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No. 85-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

AMERICAN FINANCIAL SERVICES ASSOCIATION,

Petitioner,

v.

FEDERAL TRADE COMMISSION, *et al.*,

Respondents.

PETITIONER'S APPENDIX

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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[1] Obvious typographical errors have been corrected. Citations to the corresponding pages in the Federal Register are provided in brackets.

[2] Citations to the corresponding pages in the original letter are provided in brackets.

APPENDIX A

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S.App.D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 84-1081

AMERICAN FINANCIAL SERVICES ASSOCIATION, PETITIONER

v.

FEDERAL TRADE COMMISSION, RESPONDENT

SILAS BROWN, et al.,
AMERICAN CONFERENCE OF
UNIFORM CONSUMER CREDIT CODE STATES, INTERVENORS

No. 84-1167

THE SOUTH CAROLINA DEPARTMENT OF
CONSUMER AFFAIRS, PETITIONER

v.

FEDERAL TRADE COMMISSION, RESPONDENT

AMERICAN CONFERENCE OF
UNIFORM CONSUMER CREDIT CODE STATES,
AMERICAN FINANCIAL SERVICES ASSOCIATION,
DEPARTMENT OF COMMERCE OF THE STATE OF MONTANA,
INTERVENORS

Petitions for Review of an Order of the
Federal Trade Commission

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

Argued February 22, 1985

Decided July 12, 1985

David H. Remes, with whom *William H. Allen* was on the brief, for petitioner/intervenor American Financial Services Association in Nos. 84-1081 and 84-1167.

Steven W. Hamm, with whom *Philip S. Porter* and *J.M. Edouard Mille* were on the brief, for petitioner South Carolina Department of Consumer Affairs in No. 84-1167. *Philip S. Porter* and *J.M. Edouard Mille* were also on the brief for intervenor American Conference of Uniform Consumer Credit Code States in Nos. 84-1081 and 84-1167.

Ernest J. Isenstadt, Assistant General Counsel, Federal Trade Commission, with whom *Howard E. Shapiro*, Deputy General Counsel, Federal Trade Commission was on the brief, for respondent in Nos. 84-1081 and 84-1167.

J. Alan Galbraith, for intervenors Silas Brown, *et al.* in No. 84-1081. *Charles Hill* entered an appearance for intervenors.

Francis X. Bellotti was on the brief, for Commonwealth of Massachusetts, *et al.*, *amicus curiae*, in Nos. 84-1081 and 84-1167. *Rex Butler* entered an appearance for *amicus curiae* in No. 84-1081.

Edwin Lloyd Pittman was on the brief for the Commissioner of Banking and Consumer Finance of the State of Mississippi, *amicus curiae*, in Nos. 84-1081 and 84-1167.

R. Stuart Broom was on the brief for National Association of Consumer Credit Administrators, *amicus curiae*, in Nos. 84-1081 and 84-1167.

Before: TAMM, WALD and EDWARDS, *Circuit Judges*.

Opinion for the Court filed by *Circuit Judge* WALD.

Dissenting opinion filed by *Circuit Judge* TAMM.

WALD, *Circuit Judge*: In these consolidated cases, the petitioners, American Financial Services Association (AFSA) and South Carolina Department of Consumer Affairs (SCDCA) seek review of the Federal Trade Commission's ("the FTC" or "the Commission") Trade Regulation Rule on Credit Practices ("the Credit Practices Rule" or "the Rule"), pursuant to section 18(e) of the Federal Trade Commission Act ("the FTC Act"), 15 U.S.C. § 57a(e)(1)(A).[1] After thorough consideration of the record, we find the promulgation of the Credit Practices Rule was within the Commission's authority under sections 5(a)(1) and 18(a)(1)(B) of the FTC Act, that the Rule is supported by substantial evidence in the record, and that the Rule does not effect an unlawful preemption of state law.

I. THE RULEMAKING AND PETITIONERS' CHALLENGE

The Commission's rulemaking on creditor remedies originated as a result of two national studies of consumer credit transactions. As part of the Consumer Credit Protection Act of 1968, Congress established the National Commission on Consumer Finance and charged it with conducting a study of consumer credit transactions including an assessment of existing regulatory measures to protect against unfair practices and to ensure the informed use of consumer credit. The National Commis-

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[1] Petitioner AFSA is an association of over 550 consumer finance and small-loan companies. Additional briefs in support of the petitioners were filed by intervenor American Conference of Uniform Consumer Credit Code States (ACUCCS) and amici the National Association of Consumer Credit Administrators and the Commissioner of Banking and Consumer Finance of the State of Mississippi. Additional briefs in support of the respondent were filed by intervenors Silas Brown, Community Thrift Clubs, Inc. and the National Consumer Law Center and amici the Attorneys General of Arkansas, Illinois, Kentucky, Maine, Massachusetts, Michigan, Minnesota, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, Tennessee and Wisconsin.

sion on Consumer Finance's final report, based on an extensive survey, identified a number of abusive practices and recommended curtailment of a variety of boilerplate provisions commonly found in consumer credit contracts. *See* Consumer Credit in the United States, Report of the National Commission on Consumer Finance (1972), Joint Appendix ("J.A.") at 3 [hereinafter cited as NCCF study]. Between 1972 and 1974, the FTC's Bureau of Consumer Protection also conducted an investigation of the consumer finance industry to determine whether the use of certain collection remedies was an unfair practice within the meaning of section 5 of the FTC Act. As a result of this investigation, the Bureau of Consumer Protection recommended that the FTC propose a trade regulation rule branding certain creditor remedies as unfair trade practices. *See* Memorandum to Commission from Division of Special Projects, Bureau of Consumer Protection, Creditor Remedies Project (April 1974), J.A. at 74 [hereinafter cited as Creditor Remedies Project].

On April 11, 1975, the Commission published its initial notice of rulemaking on consumer credit practices. Credit Practices Rule, 40 Fed. Reg. 16,347 (1975). The initial notice of rulemaking proposed a rule proscribing or restricting the use of eleven creditor practices or remedies: confessions of judgment; waivers of exemption; wage assignments; security interests in household goods; cross-collateralization; blanket security interests; resale of repossessed collateral; imposition of attorneys' fees in connection with debt collection; pyramiding of late charges; third party contacts; and co-signer liability. Following the comment and hearing stages of the rulemaking,[2] reports were prepared and submitted to the

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[2] Numerous written comments were received through August 5, 1977. Included among the commenters were banks, finance companies, retailers, credit unions, savings and loan associations, various trade associations, legal aid attorneys,

Commission by the Presiding Officer, *see* Report of the Presiding Officer on Proposed Trade Regulation Rule: Credit Practices (August 1978), J.A. at 330 [hereinafter cited as P.O. Report], and by the Commission staff, *see* Credit Practices: Staff Report and Recommendation on Proposed Trade Regulation Rule (August 1980), J.A. at 704 [hereinafter cited as Staff Report]. The publication of the Staff Report triggered a 60-day comment period, *see* 16 C.F.R. § 1.13(h) (1985), which was extended until January 16, 1981. On April 14, 1983, the rulemaking staff's memorandum recommending a final modified proposed rule and memoranda from the Commission's Bureau of Economics and Bureau of Consumer Protection were placed on the public record.[3] Prior rule-

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consumer groups, governmental entities, and consumers. Banks and saving and loan institutions while not subject to the FTC's regulatory jurisdiction, nonetheless submitted comments because they are affected by the Credit Practices Rule. The Federal Reserve Board and the Federal Home Loan Bank Board are required to promulgate rules applicable to banks and saving and loan associations that are "substantially similar" to the FTC's rule within 60 days after the FTC's rule takes effect unless the Boards affirmatively find that the covered practices are not unfair or deceptive, or find that the rule would "seriously conflict with essential monetary and payments systems policies." *See* 15 U.S.C. § 57a(f)(1). The Federal Reserve Board published a "substantially similar" credit practices rule on May 8, 1985. *See* 50 Fed. Reg. 19,325 (1985) (to be codified at 12 C.F.R. pt 535).

A final notice of rulemaking was published on June 24, 1977, 42 Fed. Reg. 32,259 (1977), setting forth a schedule of public hearings and enumerating 14 issues for consideration designated by the Presiding Officer pursuant to 16 C.F.R. § 1.13(d)(1) (1985). The hearings were conducted between September 12, 1977, and January 30, 1978, in Dallas, Texas, Chicago, Illinois, San Francisco, California, and Washington, D.C. Rebuttal submissions were then received until May 1, 1978.

[3] *See* Memorandum to the Commission from Division of Credit Practices (July 20, 1981) (Staff's Final Recommendations on the Proposed Credit Practices Trade Regulation Rule),

making participants were invited to present their views orally directly to the Commission on June 6 and 7, 1983. On June 13, 1983, the Commission met to consider whether to promulgate a rule and what form the rule should take. The Commission rejected several provisions of the rule and modified others.[4] On July 20, 1983, the Commission tentatively adopted, by unanimous vote, the revised proposed rule. The final rule was published on March 1, 1984, to become effective March 1, 1985. Credit Practices Rule, 49 Fed. Reg. 7740 (1984) (codified at 16

J.A. at 1581 [hereinafter cited as Staff's Final Recommendations]; Memorandum to Commission from Timothy Muris, Director of Bureau of Consumer Protection (April 4, 1983) ("Muris Memorandum"), J.A. at 1823; Memorandum to Commission from Richard Higgins, Deputy Director of Bureau of Economics (April 5, 1983) ("Higgins Memorandum"), J.A. at 1876; Memorandum to Commission from Division of Consumer Protection, Bureau of Economics (April 7, 1983), J.A. at 1892 [hereinafter cited as Bureau of Economics Final Recommendations]; Memorandum to Commission from Wendy Lee Gramm, Director of Bureau of Economics (April 7, 1983) ("Gramm Memorandum"), J.A. at 1932.

[4] The Commission rejected draft provisions governing the resale of repossessed collateral, the imposition of attorneys' fees in connection with debt collection, a practice known as cross collateralization, and creditor contacts with third parties. *See* 40 Fed. Reg. 16,347 (April 11, 1975) (originally proposed rule, relevant sections to be codified at 16 C.F.R. § 444.2(a) (5), (7), (8), (10)); *see also* 49 Fed. Reg. at 7783-87 (explaining rejection of provisions relating to resale of repossessed collateral and third party contacts); Staff Report, J.A. at 965-1182, 1195-1237 (discussing objections to proposed provisions ultimately rejected). The household goods provision was substantially modified to provide a narrow definition of household goods covering only "common household necessities" and to make clear that the provision only applied to non-possessory security interests. *See* 49 Fed. Reg. at 7767-68. The scope of the original wage assignment provision was similarly narrowed to exclude from its coverage revocable wage assignments, preauthorized payroll deduction plans, and already earned wages. In addition a definition of "earnings" was added. *See* 49 Fed. Reg. at 7760-61.

C.F.R. pt 444). In sum, the Credit Practices Rule was painstakingly considered and significantly modified in response to the extensive comments and recommendations received during this long rulemaking proceeding.

The Credit Practices Rule as finally promulgated contains provisions relating to the following creditor remedies: confessions of judgment; wage assignments; security interests in household goods; waivers of exemption; pyramiding of late charges; and cosigner liability. Petitioners, as a whole, specifically challenge the provisions relating to wage assignments and security interests in household goods. The challenged provisions read in pertinent part:

> (a) In connection with the extension of credit to consumers in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller directly or indirectly to take or receive from a consumer an obligation that:
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> . . . .
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> . . . .
>
> (3) Constitutes or contains an assignment of wages or other earnings unless:
>
> (i) The assignment by its terms is revocable at the will of the debtor, or
>
> (ii) The assignment is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the consumer authorizes a series of wage deductions as a method of making each payment, or
>
> (iii) The assignment applies only to wages or other earnings already earned at the time of the assignment.
>
> (4) Constitutes or contains a nonpossessory security interest in household goods other than a purchase money security interest.

16 C.F.R. § 444.2(a)(3)-(4). Household goods are defined as:

> (i) . . . Clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, and personal effects (including wedding rings) of the consumer and his or her dependents, provided that the following are not included within the scope of the term "household goods":
>
> (1) Works of art;
>
> (2) Electronic entertainment equipment (except one television and one radio);
>
> (3) Items acquired as antiques; and
>
> (4) Jewelry (except wedding rings).
>
> (j) *Antique.* Any item over one hundred years of age, including such items that have been repaired or renovated without changing their original form or character.

16 C.F.R. § 444.1(i)-(j).

A non-purchase, non-possessory security interest in household goods ("HHG security interest") allows the creditor to seize and sell the debtor's household goods upon default without a judgment or court order. Similarly, a wage assignment allows the creditor to file the assignment with the debtor's employer and receive all or part of the debtor's wages until the debt is satisfied without first obtaining a court judgment. The Commission found that both these creditor remedies were "unfair" because they cause substantial and unavoidable injury to consumers which is not outweighed by countervailing benefits to consumers or competition. Petitioners argue that the Rule is beyond the Commission's section 5 authority to proscribe unfair practices because in the absence of seller overreaching in the form of deceit, coercion or nondisclosure of material information, the FTC may not intercede in the market as an "invisible hand" to obtain "better bargains" for consumers.

The petitioners' challenges to the household goods and wage assignment provisions of the Credit Practices Rule raise the following issues [5]:

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[5] Petitioner AFSA argues that even if the challenged provisions of the Rule are found to be valid exercises of FTC authority, the court should still remand the Rule for further consideration in light of changes which have occurred in the consumer credit market since the bulk of the rulemaking record was compiled. AFSA Brief at 71-74 (citing the enactment of the Bankruptcy Reform Act of 1978; the increase in use of second mortgages for non-housing related loans; the emergence of banks as a stronger competitor in the consumer credit market; and the deregulation of state interest rate ceilings). Courts generally are reluctant to base a remand on the ground that the evidence has grown stale. American Optometric Ass'n v. FTC, 626 F.2d 896, 906-07 (D.C. Cir. 1980) (remand warranted due to intervening Supreme Court decision while judicial review of rule was pending). In *American Optometric*, this court recognized that the equities of a situation may militate in favor of a remand " 'where there has been a change in circumstances . . . that is not merely "material" but rises to the level of a change in "core" circumstances, the kind of change that goes to the very heart of the case.' " 626 F.2d at 907 (quoting Greater Boston Television Corp. v. FCC, 463 F.2d 268, 283 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 950 (1972)). AFSA has cited no "core" change in circumstances which go to "the very heart of the case." In fact, AFSA acknowledges that none of the intervening developments cited provide any "decisive answers" to the Commission's stated justifications for the Rule. AFSA Brief at 73. AFSA merely asserts that *if the purported effects* of the new developments *were confirmed as true* then certain portions of the FTC's reasoning may be undercut. On the other hand, the effects of the new developments cited may bolster the Commission's reasoning. *See* FTC Brief at 70-71. Moreover, the staff's final recommendations on the Rule included a discussion of the impact of developments in the credit market since the completion of the hearings. *See* Staff's Final Recommendations, J.A. at 1601-08. Thus subsequent developments were not completely overlooked by the Commission. AFSA has not carried the heavy burden of showing a change in "core" circumstances necessitating a remand. *Cf.* ICC v. Jersey City, 322 U.S. 503, 514 (1944) ("If upon the coming down of the

(1) Has the FTC exceeded its statutory authority to define unfair acts or practices under section 5(a)(1) of the FTC Act?

(2) Has the FTC exceeded its rulemaking authority under section 18(a)(1)(B) of the FTC Act by failing to define with specificity the acts or practices deemed unfair?

(3) Are the Commission's unfair practice determinations supported by substantial evidence in the rulemaking record?

(4) Has the Commission exceeded its authority by providing an overly broad remedy for preventing the identified unfair practice?

(5) Has the Commission exceeded its authority by preempting state laws and regulations governing consumer credit transactions? [6]

II. Scope of FTC Authority Under the Unfairness Doctrine

Petitioners claim that in promulgating the challenged provisions of the Credit Practices Rule, the FTC acted beyond its statutory authority to define unfair acts and practices and to promulgate rules proscribing those acts or practices under sections 5 and 18 of the FTC Act.

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order litigants might demand rehearings as a matter of law because some new circumstance has arisen, some new trend has been observed, or some new fact discovered, there would be little hope that the administrative process could ever be consummated in an order that would not be subject to reopening.").

[6] While only specifically challenging the household goods provision of the Rule, petitioner SCDCA appears to make a broader preemption challenge claiming that the Credit Practices Rule as a whole gratuitously supplants South Carolina's comprehensive consumer credit laws. The preemption challenge is addressed *infra* at Part IV.

In order to evaluate petitioners' claims within the proper perspective, the development and current status of the FTC's unfairness authority must be recounted. As this court stated in *National Petroleum Refiners Ass'n* v. *FTC*, 482 F.2d 672, 674 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 951 (1974): "The Federal Trade Commission is a creation of Congress, not a creation of judges' contemporary notions of what is wise policy. The extent of its powers can be decided only by considering the powers Congress specifically granted it in the light of the statutory language and background." (citations omitted).

A. *Evolution of the FTC's Authority to Identify and Proscribe Unfair Practices*

Congress created the FTC in 1914 and delegated to it the power to determine and prevent "unfair methods of competition" in commerce. Federal Trade Commission Act, ch. 311, § 5, 38 Stat. 719 (1914) (current version at 15 U.S.C. § 45(a)(1)). At the time of this original delegation, Congress explicitly rejected enacting a statutory definition of the term "unfair methods of competition." *See* S. Rep. No. 597, 63d Cong., 2d Sess. 13 (1914) ("The committee gave careful consideration to . . . whether it would attempt to define the many and variable unfair practices which prevail in commerce . . . or whether it would . . . leave it to the commission to determine what practices were unfair. It concluded that the latter course would be better . . . ."). Congress' rationale is clearly articulated in the House Conference Report:

> It is impossible to frame definitions which embrace all unfair practices. There is no limit to human inventiveness in this field. Even if all known unfair practices were specifically defined and prohibited, it would be at once necessary to begin over again. If Congress were to adopt the method of definition, it would undertake an endless task. It is also practically impossible to define unfair practices

> so that the definition will fit business of every sort in every part of this country. Whether competition is unfair or not generally depends upon the surrounding circumstances of the particular case. What is harmful under certain circumstances may be beneficial under different circumstances.

H.R. Conf. Rep. No. 1142, 63d Cong., 2d Sess. 19 (1914).

This broad grant of discretionary authority led to two early judicial attempts to cabin the FTC's authority to define unfair practices by limiting the covered practices to those which unduly hinder competition or tend to create monopolies. *See, e.g., FTC* v. *Raladam Co.*, 283 U.S. 643 (1931); *FTC* v. *Gratz*, 253 U.S. 421 (1920). Subsequent judicial and congressional action, however, overturned these attempts to narrowly circumscribe the FTC's authority.

In *FTC* v. *R.F. Keppel & Bro., Inc.*, 291 U.S. 304 (1934), the FTC issued a cease and desist order under section 5 to prevent a manufacturer from selling candy using a marketing method which tempted children to gamble even though the marketing scheme involved no fraud or deception and could be adopted by competing manufacturers. In finding the practice contrary to public policy and thus unfair within the meaning of section 5, the Supreme Court stated:

> [W]e cannot say that the Commission's jurisdiction extends only to those types of practices which happen to have been litigated before this court.
>
> Neither the language nor the history of the Act suggests that Congress intended to confine the forbidden methods to fixed and unyielding categories.

Id. at 309-10.

Congress confirmed the Supreme Court's view of the FTC's authority by enacting the Wheeler-Lee Amendment in 1938. Ch. 49, § 3, 52 Stat. 111 (1938) (codified

at 15 U.S.C. § 45(a)). This amendment broadened the language of section 5 to read:

> The Commission is empowered and directed to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in commerce and *unfair or deceptive acts or practices in commerce.*

15 U.S.C. § 45(a)(6) (emphasis added to indicate amended language). One of the primary purposes of this amendment was "to broaden the powers of the Federal Trade Commission over unfair methods of competition by extending its jurisdiction to cover unfair or deceptive acts or practices in commerce." H.R. Rep. No. 1613, 75th Cong., 1st Sess. 1 (1937). The amendment was engendered in large measure by judicial decisions limiting the FTC's authority to practices unfairly inhibiting competition. *Id.* at 3 (discussing *Raladam* decision); 83 Cong. Rec. 395 (1938) ("The trouble arises, and is continually increasing from court decisions construing the language of the existing law. These accumulated decisions over a period of years have so hedged in the Commission that there is great need for amendments of an enlarging character if the full effectiveness of the objects sought are to be attained."). Congress' intent was affirmatively to grant the Commission authority to protect consumers as well as competitors.

> By the proposed amendment to section 5, the Commission can prevent such acts or practices which injuriously affect the general public as well as those which are unfair to competitors. In other words, this amendment makes the consumer, who may be injured by an unfair trade practice, of equal concern, before the law, with the merchant or manufacturer injured by the unfair methods of a dishonest competitor.

H.R. Rep. No. 1613, 75th Cong., 1st Sess. 3 (1937).

Despite the passage of the Wheeler-Lee Amendment in 1938, Congress found that "the FTC continued to be hampered as an effective force in promoting fair and free competition and safeguarding the consumer public against unfair or deceptive acts or practices by the scope of its authority being limited to matters 'in commerce' and by being made to rely solely on the cease and desist order procedure for enforcement." H.R. Rep. No. 1107, 93d Cong., 2d Sess. 29 (1974). House Report No. 1107 noted the growing consumer consciousness which had developed during the sixties and cited two oversight studies of the FTC which were extremely critical of the FTC's lack of effectiveness in carrying out its consumer protection responsibilities. *Id.* at 33-34 (citing American Bar Association, Report of the Commission to Study the Federal Trade Commission (1969); E. Cox, R. Felimuth & J. Schulz, "The Nader Report" on the Federal Trade Commission (1969)). "Both reports noted the need for additional statutory authority to permit the FTC to carry out its consumer protection responsibilities." *Id.* at 34. Congress thus enacted the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act "to codify the Commission's authority to make substantive rules for unfair or deceptive acts or practices in or affecting commerce."[7] H.R. Conf. Rep. No. 1606, 93d Cong., 2d Sess 31 (1974). The conferees regarded this "as an important power by which the Commission can fairly and efficiently pursue its important statutory mission." *Id.* The Magnuson-Moss Act added section 18 to the FTC Act, 15 U.S.C. § 57a, which provides:

(1) . . . [T]he Commission may prescribe—

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[7] This court in *National Petroleum Refiners Ass'n*, 482 F.2d 672, had construed section 6(g) of the FTC Act, 15 U.S.C. § 46(g), as conferring upon the Commission the authority to promulgate substantive trade regulation rules.

> (A) interpretive rules and general statements of policy with respect to unfair or deceptive acts or practices in or affecting commerce (within the meaning of section 45(a)(1) of this title), and
>
> (B) rules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce (within the meaning of section 45(a)(1) of this title). . . . Rules under this subparagraph may include requirements prescribed for the purpose of preventing such acts or practices.[8]

15 U.S.C. § 57a(a)(1)(A), (B).

B. *Discerning Limits on the FTC's Authority to Define Unfair Practices*

While both the Wheeler-Lee Amendment and the Magnuson-Moss Act legitimized and facilitated the Commission's consumer protection activities, neither shed much light on the standards to be used in identifying unfair acts or practices. Congress has not at any time withdrawn the broad discretionary authority originally granted the Commission in 1914 to define unfair practices on a flexible, incremental basis.[9] Courts have accordingly

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[8] The Magnuson-Moss Act also amended section 5, 15 U.S.C. § 45(a)(1), to include the term "or affecting commerce." Section 5(a)(1) currently reads:

> Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful.

[9] The most Congress has done to constrict the FTC's authority to make unfairness determinations is to impose special procedural requirements. For example, the Magnuson-Moss Act granted the Commission rulemaking authority but imposed upon the Commission rulemaking procedures and judicial review provisions stricter than those contained in the Administrative Procedure Act. The House Committee wrote:

> Your committee believes these [APA] rulemaking procedures and this scope of judicial review may be in-

adopted a malleable view of the Commission's authority. *See, e.g., FTC* v. *Sperry & Hutchinson Co.*, 405 U.S. 233, 244 (1972) (comparing FTC to a court of equity in carrying out implementation of the "elusive, but congressionally mandated standard of fairness"); *Atlantic Refining Co.* v. *FTC*, 381 U.S. 357, 367 (1965) (Congress intentionally left the development of the term "unfair" to the Commission); *R.F. Keppel & Bro.*, 291 U.S. at 310 (Congress did not intend to confine forbidden practices to "fixed and unyielding categories"). Nonetheless as this court has stated: "The Commission is hardly free to write its own law of consumer protection . . . ." *National Petroleum Refiners Ass'n*, 482 F.2d at 693. The Commission's exercise of its unfairness authority in any particular instance is subject to judicial review and may be affirmed or set aside by the court. *See Sperry & Hutchinson*, 405 U.S. at 249; *R.F. Keppel & Bro.*, 291 U.S. at 314.

The judiciary remains the final authority with respect to questions of statutory construction and must reject administrative agency actions which exceed the agency's statutory mandate or frustrate congressional intent. *See, e.g., FEC* v. *Democratic Senatorial Campaign Comm.*, 454 U.S. 27, 32 (1981); *Volkswagenwerk* v. *FMC*, 390 U.S. 261, 272 (1968); *NLRB* v. *Brown*, 380 U.S. 278, 291 (1965); *FTC* v. *Colgate-Palmolive Co.*,

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adequate in some cases where fundamental factual premises of a rule are at issue. Because of the potentially pervasive and deep effect of rules defining what constitutes unfair or deceptive acts or practices and the broad standards which are set by the words "unfair or deceptive acts or practices", the committee believes greater procedural safeguards are necessary. Accordingly, it has fashioned the rulemaking procedures and judicial review provisions described below which we believe to be more appropriate in this context than merely relying upon the provisions of sections 553 and 706 of title 5.

H.R. Rep. No. 1107, 93d Cong., 2d Sess. 45-46 (1974).

380 U.S. 374, 385 (1965). The Supreme Court has made clear, however, that in reviewing an agency's construction of a statute which it administers, courts must give deference to the agency's interpretation:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.

Chevron, U.S.A., Inc. v. *Natural Resources Defense Council, Inc.*, 104 S. Ct. 2778, 2782 (1984); *see also Colgate-Palmolive Co.*, 380 U.S. at 385 ("This Court has frequently stated that the [FTC's] judgment is to be given great weight by reviewing courts."). Thus we must perform our "quintessential" judicial function of determining whether the Commission has acted within the bounds of its statutory authority while at the same time according due deference to the Commission's judgment as to what constitutes an unfair practice. We do not understand the dissent to disagree with the foregoing principles of judicial review. *See* Dissent at 1-2. We are consequently taken aback by its characterization of our performance as being "anesthetized" by deference to the Commission. *See* Dissent at 15-16. In our view, it is the dissent that would stray outside the established bounds of judicial review and effectively usurp the role of the FTC. The dissent presents its own *selective* review of the Commission's stated rationale while disregarding the totality of the Commission's reasoning, and ultimately supplants the final judgment of all five Commissioners with respect to the wisdom of their determination that the taking of HHG security interests and wage assignments are unfair creditor practices. We decline to view our role so broadly. *See Atlantic Refining Co.*, 381 U.S. at 367 ("[O]ur function is limited to determining whether the Commission's decision 'has "warrant in

the record" and a reasonable basis in law.') (quoting *NLRB* v. *Hearst Publications, Inc.*, 322 U.S. 111, 131 (1944)).

The broad delegation of discretionary authority to the FTC to define unfair practices makes our task particularly difficult in this case. In ascertaining whether the FTC has exceeded the limits of its statutory authority by defining HHG security interests and wage assignments as unfair creditor practices we would be materially aided by a particularization of the congressionally intended legal standard for assessing the fairness of particular acts or practices. Yet, Congress has expressly declined to delineate such a legal standard claiming that the standard must be stated in broad terms to allow the Commission to respond to evolving market conditions and practices. If that were Congress' last word, the court would be left with two equally unattractive alternatives: articulating a legal standard of unfairness which Congress has expressly refused, on policy grounds, to articulate or deciding the reasonableness of the Commission's unfairness determination based on our own views of what should be deemed an unfair practice without benefit of any concrete standards for judgment. Fortunately recent interactions between Congress and the Commission provide the court with some tangible guideposts for review.

Considerable controversy developed during the mid to late seventies over the FTC's exercise of its consumer unfairness regulatory authority. Spurred on by the criticisms in the late sixties of the Commission's lack of effectiveness in the realm of consumer protection, the prodding of congressional committees, and the passage of the Magnuson-Moss Act, the Commission vigorously stepped up its consumer protection activities under its unfairness regulatory authority. *See supra* p. 14; H.R. Rep. No. 809, Pt. 1, 97th Cong., 2d Sess. 10-11 (1982). The Commission's new activism engendered commentators' criticism of the vagueness and breadth of the unfairness

doctrine.[10] The controversy over the Commission's consumer protection activities peaked in the late-1970's with the Commission's particularly controversial foray into regulation of television advertising directed at children; the proposed rule would have completely prohibited the advertising of certain products during "children's programming." [11]

In response to this controversy, Congress enacted the Federal Trade Commission Improvements Act of 1980,

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[10] *See, e.g.*, Erxleben, The FTC's Kaleidoscopic Unfairness Statute: Section 5, 10 Gonz. L. Rev. 333 (1975); Nelson, The Politicization of FTC Rulemaking, 8 Conn. L. Rev. 413 (1976); Schwartz, Regulating Unfair Practices Under the FTC Act: The Need for a Legal Standard of Unfairness, 11 Akron L. Rev. 1 (1977).

[11] *See* Children's Advertising, Notice of Proposed Rulemaking, 43 Fed. Reg. 17,967 (1978). The trade regulation rule proposed by the FTC staff was an attempt to deal comprehensively with the entire area of television advertising to children. The proposed rule included three elements:

> (a) Ban all televised advertising for any product which is directed to, or seen by, audiences composed of a significant proportion of children who are too young to understand the selling purpose of or otherwise comprehend or evaluate the advertising;
>
> (b) Ban televised advertising for sugared food products directed to, or seen by, audiences composed of a significant proportion of older children, the consumption of which products poses the most serious dental health risks;
>
> (c) Require televised advertising for sugared food products not included in Paragraph (b), which is directed to, or seen by, audiences composed of a significant proportion of older children, to be balanced by nutritional and/or health disclosures funded by advertisers.

Id. at 17,969. In addition, the Commission requested comments on a number of broad remedial measures, including requiring advertisers of highly carciogenic products to fund separate advertisements disclosing the products risks and nutritional value. *Id.*

Pub. L. No. 96-252, 94 Stat. 374 (codified as amended in scattered sections of 15 U.S.C.) which suspended the Commission's controversial rulemaking on children's advertising and placed a moratorium on the initiation of any new rulemakings aimed at regulating commercial advertising as an unfair practice pending congressional oversight hearings.[12] Although Congress has subsequently solicited statements and held oversight hearings on the question of whether the FTC's unfairness authority should be eliminated or permanently restricted,[13] it

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[12] Congress' limitation of the Commission's unfairness authority with respect to commercial advertising was motivated by the threat the FTC's broad industry-wide rulemaking authority posed to first amendment interests in the area of commercial speech. *See* H.R. Conf. Rep. 917, 96th Cong., 2d Sess. 32 (1980) ("The conference made these amendments regarding the children's advertising proceeding because of their concern that it raises fundamental issues of free speech and due process. The conferees expect the Commission to seriously weigh these concerns in further proceedings, if any.").

The FTC Improvements Act of 1980 also provided for a two house legislative veto, whereby a FTC trade regulation rule could be overturned by adoption within 90 days of a concurrent resolution disapproving the rule. This veto provision was subsequently declared unconstitutional by this court. *See* Consumers Union, Inc. v. FTC, 691 F.2d 575 (D.C. Cir. 1982).

[13] *See* Senate Comm. on Commerce, Science, and Transportation, 96th Cong., 2d Sess., Unfairness: Views on Unfair Acts and Practices in Violation of the Federal Trade Commission Act (Comm. Print 1980) (collection of public comments); Federal Trade Commission Reauthorization, Hearings Before the Subcomm. on Commerce, Transportation, and Tourism of the House Comm. on Energy and Commerce, 97th Cong., 2d Sess. (1982); Reauthorization of the Federal Trade Commission, Hearings Before the Senate Comm. on Commerce, Science, and Transportation, 97th Cong., 2d Sess. (1982); Federal Trade Commission Reauthorization—1983, Hearings Before the Subcomm. on Commerce, Transportation and Tourism of the House Comm. on Energy and Commerce, 98th Cong., 1st Sess. (1983); Federal Trade Commission Reauthorization, Hearings Before the Senate Comm. on Com-

has taken no definitive legislative action to define the limits of that authority. Bills were introduced in both the 97th and 98th Congresses which would have amended section 5 to provide a definition of unfair acts or practices.[14] The definition proposed in these bills was the definition supplied by the Commission at the request of Congress in a 1980 policy statement. *See* Letter from Federal Trade Commission to Senators Ford and Danforth (Dec. 17, 1980), *reprinted in* H.R. Rep. No. 156, Pt. 1, 98th Cong., 1st Sess. 33-40 (1983) [hereinafter

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merce, Science, and Transportation, 98th Cong., 1st Sess. (1983).

[14] *See* S. 1714, 89th Cong., 2d Sess. (1983) (reprinted and discussed in S. Rep. No. 215, 98th Cong., 1st Sess. (1983)); H.R. 2970, 98th Cong., 2d Sess. (1983) (reprinted and discussed in H.R. Rep. No. 156, Pts I-III, 98th Cong., 2d Sess. (1983)); S. 2449, 97th Cong., 2d Sess. (1982) (reprinted and discussed in S. Rep. No. 451, 97th Cong., 2d Sess. (1982)); H.R. 6995, 97th Cong., 2d Sess. (1982) (discussed in H.R. Rep. No. 809, Pts. 1-2, 97th Cong., 2d Sess. (1982)). These proposed bills sought to codify Commission policy and to provide added procedural safeguards to parties subject to FTC jurisdiction. The bills were not aimed at diminishing the Commission's authority to vigorously protect consumers. For example, House Report 809, Pt. 1 states:

> It would be a mistake, however, to interpret the provisions of the bill as designed to hobble the Commission or transform it back into the timid agency that was pilloried for its caution in the 1960's. The Committee has carefully considered all views from a wide range of business and consumer groups submitted in connection with this reauthorization. While the Committee seeks to codify certain current Commission policies and perfect the procedural safeguards available to those who are subject to Commission jurisdiction, the Committee is aware of no evidence that the need for vigorous protection of competition and consumer rights has diminished. On the contrary, the record is replete with indications from consumers, business, labor and state attorneys general, of the need for continued vigorous FTC enforcement.

H.R. Rep. No. 809, Pt. 1, 97th Cong., 2d Sess. 11 (1982).

cited as Policy Statement with page references to H.R. Rep. No. 156].

In its Policy Statement, subscribed to by all five Commissioners, the FTC responded to the criticism levelled at the Commission's implementation of its unfairness authority by delineating a concrete framework for the future application of that authority. *See* Policy Statement at 34 ("This letter thus delineates the Commission's view of the boundaries of its consumer unfairness jurisdiction and is subscribed to by each Commissioner."). The Commission noted that Congress by framing section 5 in general terms expected the underlying criteria to evolve and develop over time, thus, "[t]he present understanding of the unfairness standard is the result of an evolutionary process." *See* Policy Statement at 35. The Commission's Policy Statement was basically a refinement of an earlier three-part standard of unfairness it had set out in 1964.

In 1964 the Commission determined that enough cases had been decided to enable the Commission to identify three criteria used in determining whether a practice, which is neither anticompetitive nor deceptive, is nonetheless unfair to consumers.

> (1) whether the practice, without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law, or otherwise—whether, in other words, it is within at least the penumbra of some commonlaw, statutory, or other established concept of unfairness; (2) whether it is immoral, unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers (or competitors or other businessmen).

Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, Statement of Basis and Purpose, 29 Fed. Reg. 8355 (1964). The Commission noted that the Supreme Court

cited these criteria with apparent approval in *Sperry & Hutchinson*, 405 U.S. at 244-45 n.5. *See* Policy Statement at 36 & n.9 (citing *Spiegel, Inc.* v. *FTC*, 540 F.2d 287, 293 n.8 (7th Cir. 1976); *Heater* v. *FTC*, 503 F.2d 321, 323 (9th Cir. 1974)). The Supreme Court appended footnote 5, citing what have come to be termed the "S & H criteria," to the following statement comparing the FTC to a court of equity:

> [T]he Federal Trade Commission does not arrogate excessive power to itself if, in measuring a practice against the elusive, but congressionally mandated standard of fairness, it, like a court of equity, considers public values beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws.

Sperry & Hutchinson, 405 U.S. at 244. In *Sperry & Hutchinson*, the Supreme Court thus put its stamp of approval on the Commission's evolving use of a consumer unfairness doctrine not moored in the traditional rationales of anticompetitiveness or deception.[15]

In its 1980 policy statement addressed to Congress, the Commission stated that since *Sperry & Hutchinson*, "the Commission has continued to refine the standard of unfairness in its cases and rules, and it has now reached a more detailed sense of both the definition and the limits of these criteria." Policy Statement at 36. The Commission set forth the following standard for identifying practices which are unfair to consumers:

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[15] The Commission's reliance on a consumer unfairness rationale as an independent basis for its actions is of comparatively recent origin. More often the Commission's actions have been based on alternate theories of deception and unfairness. *See generally* Averitt, The Meaning of "Unfair Acts or Practices" in Section 5 of the Federal Trade Commission Act, 70 Geo. L.J. 225 (1981); Craswell, The Identification of Unfair Acts and Practices By the Federal Trade Commission, 1981 Wis. L. Rev. 107.

> To justify a finding of unfairness the injury must satisfy three tests. It must be substantial; it must not be outweighed by any countervailing benefits to consumers or competition that the practice produces; and it must be an injury that consumers themselves could not reasonably have avoided.

Id. It was this standard that the Commission relied on in determining that the taking of HHG security interests and wage assignments were unfair practices. *See* Credit Practices Rule, 49 Fed. Reg. at 7743.

While the Commission's three-part unfairness standard sets forth an abstract definition of unfairness focusing on "unjustified consumer injury," it does little towards delineating the specific "kinds" of practices or consumer injuries which it encompasses.[16] Yet petitioners' challenge

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[16] This deficiency has been noted by commentators. Two members of the Commission's Office of Planning have written articles attempting to clarify the implementation of the standard. *See* Averitt, *supra* note 15 (suggesting that the Commission's unfairness jurisdiction is best viewed in terms of consumer sovereignty—actionable injury arises from practices which undermine a consumer's ability to choose freely from a range of options); Craswell, *supra* note 15 (cataloguing the "kinds" of commercial practices which have been determined to be unfair in past Commission decisions). Other commentators have disparaged the Policy Statement precisely for its failure to provide an adequately workable "legal standard" to guide the FTC or the courts. *See, e.g.*, Gellhorn, Trading Stamps, S & H, and the FTC's Unfairness Doctrine, 1983 Duke L. J. 903, 957 ("Without a more explicit economic focus, however, this modification still allows the FTC and the courts to roam freely in applying the unfairness doctrine."); Rice, Consumer Unfairness at the FTC: Misadventures in Law and Economics, 52 Geo. Wash. L. Rev. 1, 56 (1984) (providing an economic perspective on the proposed consumer-injury test and suggesting that it provides "no guidance for the identification of factors that focus and aid the reasoned determination of the issue of legality in specific situations").

in this case raises the exact question left open by the Commission's standard—what specific types of unfair practices and resultant consumer injuries are cognizable? Petitioners' claim that the Commission has exceeded its statutory authority to proscribe unfair practices is predicated on their arguments that the FTC has no authority to proscribe the "kinds" of practices or prevent the "kinds" of consumer injury at issue in this case. Thus despite the Policy Statement's purpose of providing greater certainty in application of the unfairness doctrine, it falls short of providing any concrete guidance to the court in resolving the issues raised by petitioners in this case. To date, however, the consumer injury test is the most precise definition of unfairness articulated by either the Commission or Congress.[17] Thus we determine the validity of the Commission's actions by reviewing the reasonableness of the Commission's application of the consumer injury test to the facts of this case, and the consistency of that application with congressional policy and prior Commission precedent. *See Atlantic Refining Co.*, 381 U.S. at 367 ("Where the Congress has provided that an administrative agency initially apply a broad statutory term to a particular situation, our function is limited to determining whether the Commission's decision 'has "warrant in the record" and a reasonable basis in law.') (quoting *NLRB* v. *Hearst Publications, Inc.*, 322 U.S. 111, 131 (1944)).

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[17] The Fourth Circuit appears to be the only appellate court to date which has reviewed an FTC unfairness rulemaking undertaken pursuant to the Policy Statement's three-part consumer injury standard. *See* Harry & Bryant Co. v. FTC, 726 F.2d 993, 999-1000 (4th Cir.) (upholding FTC unfairness determination), *cert. denied*, 105 S. Ct. 91 (1984). Contrary to the dissent's assertion, *see* Dissent at note 1, we are entirely consistent in our stated views regarding the Policy Statement. While the Policy Statement does provide "some tangible guideposts for review," *supra* p. 18, upon which we rely, *see infra* pp. 26-37, it nonetheless falls short of providing *definitive* answers to the issues raised by petitioners in this case.

C. *The FTC's Exercise of Unfairness Authority Under Section 5(a)*

Applying the three-part consumer unfairness standard, the Commission found that HHG security interests and wage assignments were unfair creditor remedies because they caused substantial, unjustified consumer injury. Our analysis begins with a review of the Commission's reasoning with respect to each of the three criteria set out in the consumer unfairness standard.

1. *Substantial Injury*

In elaborating the term "substantial injury" in its Policy Statement, the Commission stated that in most cases substantial injury would involve monetary harm and that "ordinarily" "emotional impact and other more subjective types of harm" would not make a practice unfair. *See* Policy Statement at 36. The Commission further clarified that it "is not concerned with trivial or merely speculative harms." *Id.* "An injury may be sufficiently substantial, however, if it does a small harm to a large number of people, or if it raises a significant risk of concrete harm." *Id.* at n.12. With these guidelines [18] in mind, we turn to the specific injuries found to result from HHG security interests and wage assignments.

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[18] In a 1982 letter to Senators Packwood and Kasten, FTC Chairman Miller reiterated the Commission's view on what constitutes a substantial injury:

> As a federal body the Commission believes its concerns should be with substantial injuries; its resources should not be used for trivial or speculative harm. As a general proposition, substantial injury involves economic or monetary harm and does not cover subjective examples of harm such as emotional distress or offenses to taste or social belief.

See Letter from FTC Chairman J.C. Miller, III to Senator Packwood and Senator Kasten (March 5, 1982), *reprinted in* H.R. Rep. No. 156, Pt. 1, 98th Cong., 1st Sess. 27, 32 (1983) [hereinafter cited at 1982 Policy Letter with page references to H.R. Rep. No. 156].

(a) *Security interests in household goods.* In return for credit, consumers may be required to give a non-possessory security interest in their household goods and personal effects. These goods may be seized by the creditor in the event of a default. *See* Credit Practices Rule, 49 Fed. Reg. at 7761. Such non-possessory security interests were not recognized at common law and are of comparatively recent origin. *Id.* Based on the rulemaking record, the Commission found the practice of securing loans with non-purchase, non-possessory security interests in household goods to be widespread, with finance companies being the preeminent users. *Id.* at 7762. HHG security interests may be created by simply checking a box labelled "chattel mortgage" or by other general provisions in the text of standard form contracts, thus, giving consumers little notice of the nature and extent of the collateral they are pledging. *Id.*

Based on evidence in the record, including the testimony of a large majority of industry witnesses, the Commission found that HHG security interests have little, if any, economic value to creditors. The creditors cannot ordinarily recover their loss on default by seizing and selling the goods. Consequently actual seizure of household goods by creditors is rare. The Commission summarized its findings as follows:

> The record reflects the fact that creditors rarely engage in actual repossession of household goods. When it does occur, the furniture and other items seized frequently have little or no economic value; occasionally, the act of seizure appears to be undertaken for punitive or psychological deterrent effect.

Id. at 7763 (footnotes omitted).

Although the household goods are of little value to creditors and are rarely seized, when seizure does occur the Commission found that it can have severe economic consequences for the consumer. The consumer, most likely already enmeshed in a financial crisis, loses the possession

and use of household necessities such as furniture, appliances, linens and kitchenware. While the monetary gain realized by the creditor upon seizure and sale of goods is minimal to nonexistent, the replacement cost to the consumer is substantial, not to mention the sentimental value of the possessions and psychological impact of the loss on the consumer. "Thus seizure often imposes a cost on the consumer which is seriously disproportionate to any benefit the creditor obtains." *Id.*

The Commission further found that even in the absence of actual seizure, HHG security interests still resulted in injury to consumers. Creditors rely on HHG security interests primarily as a "psychological lever to seek payment and to persuade consumers to take other actions the creditors may deem appropriate . . . ." *Id.* The Commission recognized that not all creditors use threats of seizure to coerce consumer response but concluded that "the preponderance of evidence supports a conclusion that such threats are commonplace." [19] *Id.* at 7764. Because the loss occasioned by the seizure of household goods is so profound, threats of seizure in themselves are uniquely harmful and disruptive to the consumer and the family.[20] *Id.* The injury resulting from "threats" or "suggestions"

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[19] For example, the Commission found that some finance company training manuals contain instruction on psychological tactics such as "chase and recheck" whereby an office representative visits the consumer's home to "check" the security and arouse the consumer's anxiety. 49 Fed. Reg. at 7764. Ledger card entries in files of debtors were found to include directives to apply pressure to family members, such as "work HHG on wife," by threatening irreparable loss of intimate possessions. *Id.*

[20] Specifically, the Commission found that "the threat to seize household possessions causes 'great emotional suffering, humiliation, anxiety, and deep feelings of guilt, and this distress can lead to physical breakdowns or illness, disruption of the family, and undue strain on family relationships.' " 49 Fed. Reg. at 7765 (quoting P.O. Report at 136, citing testimony from legal assistance attorney).

of seizure, is not limited to psychological harm. Consumers threatened with the loss of their most basic possessions become desperate and peculiarly vulnerable to any suggested "ways out." As a result, "creditors are in a prime position to urge debtors to take steps which may worsen their financial circumstances." *Id.* The consumer may default on other debts or agree to enter refinancing agreements which may reduce or defer monthly payments on a short-term basis but at the cost of increasing the consumer's total long-term debt obligation. Consumers may also forego assertion of valid defenses, set-offs or counterclaims in their haste to reach acceptable repayment agreements so as to avoid the perceived imminent seizure of their property. *Id.* at 7764-65. In sum, consumers at risk of losing their household necessities will take steps which substantially worsen their overall financial condition.

(b) *Wage assignments.* A wage assignment allows the creditor, upon filing with the debtor's employer, to receive all or a portion of the debtor's wages directly from the employer. Wage assignments, unlike wage garnishments, do not require a judgment and can be filed without any judicial review of the creditor's claim. The Commission found that wage assignments were used primarily by small loan and finance companies in California, Illinois, Michigan and New York. *Id.* at 7757. Although estimates varied, the Commission concluded that wage assignments are prevalent in states where they are permitted and are used in a significant number of consumer transactions. *Id.*

The Commission found wage assignments particularly harmful to consumers because they can be invoked without the due process safeguards of a hearing and opportunity to present defenses.[21] *Id.* Although some states

[21] Whereas pre-judgment garnishment has been found to deprive the debtor of constitutional due process rights, *see* Sniadach v. Family Finance Corp., 395 U.S. 337 (1969), prejudgment wage assignments have survived constitutional chal-

provide debtors some statutory procedural protections allowing them to prevent effectuation of a wage assignment by serving a notice of defense on the employer and creditor, the Commission found such protective schemes generally ineffective, due to lack of awareness and understanding on the part of the debtor. "[D]espite the existence of state statutes, many wage assignments result in collection by creditors even when there have [sic] been a breach of warranty, fraud, or other violation of law that may constitute a defense to payment." *Id.* at 7758.

The rulemaking record further established that wage assignments injure consumers by detrimentally injecting the creditor into the employment relationship. Employers are hostile to wage assignments due to added administrative costs and burdens and the fear that the employee's job motivation and performance will suffer as a result of the reduction in wages. *Id.* Moreover, employers tend to view the consumer's failure to repay the debt as a sign of irresponsibility. As a consequence many lose their jobs after wage assignments are filed.[22] Even if the consumer retains the job, promotions, raises, and job assignments may be adversely affected. *Id.*

Wage assignments are usually invoked at a time when the debtor is already experiencing severe financial hardship. Loss of a substantial portion of wages tends to cause further disruption of family finances and may even put at risk the wage earner's ability to provide necessities for the family. *Id.* at 7758-59. Even when wage assignments are not actually invoked, consumer injury may

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lenge because they lack the requisite state action. *See, e.g.*, Bond v. Dentzer, 494 F.2d 302 (2d Cir.), *cert. denied*, 419 U.S. 837 (1974).

[22] The Commission noted that the Consumer Credit Protection Act, 15 U.S.C. § 1674(a), prohibits employers from firing employees whose wages have been garnished. The Act does not, however, apply to wage assignments.

still result. As with HHG security interests, the Commission found that creditors use wage assignments as *in terrorem* devices to coerce consumers to pay. The invocation of a wage assignment or just simply the threat of invocation may lead a debtor to enter into costly refinancing, to improvidently default on other obligations, or to forego valid defenses. Thus consumers will act against their own best economic interests to avoid the greater potential injury of having creditors contact their employers and risk losing their jobs. "[C]reditors exploit that fear despite the fact that job loss would be economically counterproductive to the creditor." *Id.* at 7758.

The Commission, thus, concluded:

> In the absence of procedural safeguards, the potential for severe, substantial disruption of employment, the pressure that results from threats to file wage assignments, and the disruption of family finances constitute significant consumer injury. State law is inconsistent and does not offer sufficient protection to prevent this consumer injury.

Id. at 7759.

The harms to consumers resulting from the use of HHG security interests and wage assignments identified by the Commission on the basis of the rulemaking record are neither trivial or speculative nor based merely on notions of subjective distress or offenses to taste. The use of HHG security interests and wage assignments result in or create a significant risk of substantial economic and monetary harm to the consumer as well as potential deprivations of their legal rights. Hence the Commission clearly met its first criterion of establishing substantial consumer injury.

2. *Countervailing Benefits*

The Commission recognizes that most business practices entail a balancing of costs and benefits to the con-

sumer. Therefore the Commission "will not find that a practice unfairly injures consumers unless it is injurious in its net effects." Policy Statement at 37. To make this cost-benefit determination, the Commission examines the potential costs that the proposed remedy would impose on the parties and society in general. In the present case, the Commission made the following assessment:

> The potential costs of most significance in this proceeding include increased collection costs, increased screening costs, larger legal costs and increases in bad debt losses or reserves. Increased creditor costs generally would be reflected in higher interests to borrowers, reduced credit availability, or other restrictions such as increased collateral or down payment requirements.

49 Fed. Reg. at 7744 (footnotes omitted).

In weighing the costs and benefits of the Credit Practices Rule to consumers and the credit industry, the Commission first noted that the potential cost of eliminating HHG security interests and wage assignments is diminished by the presence of other remedies retained by creditors under the Rule. Creditor remedies unaffected by the Rule include the right to take purchase-money security interests which allow for repossession of the particular item purchased, to obtain a deficiency judgment or bring a suit directly on the debt, and to garnish the debtor's wages.[23] Thus, "[t]he remedies subject to the rule must be evaluated in light of their more *incremental* contribution to deterring default or reducing other cred-

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[23] Unlike HHG security interests and wage assignments, these remaining remedies do not result in the immediate seizure, without legal process, of the debtor's household necessities or wages. Though debtors may find the threat of a lawsuit disturbing, the threatened consequences are not immediate. The debtor has time to consider the options and to seek legal counsel. Moreover, the debtor's legitimate legal interests will presumably be protected through the legal process.

itor costs given remedies that remain available." *Id.* at 7744-45 (emphasis added).

Of course, to the extent HHG security interests and wage assignments actually reduce creditor costs, consumers will theoretically benefit by the greater availability of credit at a lower cost. In short, the crucial issue before the Commission was whether prohibiting HHG security interests and wage assignments would decrease availability and increase the cost of credit to consumers and, if so, whether this cost was outweighed by the benefits of the Rule to the same consumers (the benefits being the avoidance of the harms incurred by consumers as a result of the use of HHG security interests and wage assignments). Based on record evidence, the Commission concluded that the Rule would have only a marginal impact on the cost or availability of credit, and that this marginal cost was clearly overshadowed by the much greater risks to consumers resulting from the use of HHG security interests and wage assignments. *See infra* pp. 54-59. Thus we find that the Commission satisfied the second prong of the three-part consumer injury test set out in its Policy Statement.

3. *Injury is Not Reasonably Avoidable*

The requirement that the injury cannot be reasonably avoided by the consumers stems from the Commission's general reliance on free and informed consumer choice as the best regulator of the market. "Normally we expect the marketplace to be self-correcting, and we rely on consumer choice—the ability of individual consumers to make their own private purchasing decisions without regulatory intervention—to govern the market." Policy Statement at 37. As long recognized, however, certain types of seller conduct or market imperfections may unjustifiably hinder consumers' free market decisions and prevent the forces of supply and demand from maximizing benefits and minimizing costs. In such instances of

market failure, the Commission may be required to take corrective action. Such corrective action is taken "not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decisionmaking." *Id.* at 37.

The Commission found that the injuries occasioned by the use of HHG security interests and wage assignments are not reasonably avoidable by consumers for two interrelated reasons: (1) consumers are not, as a practical matter, able to shop and bargain over alternative remedial provisions; and (2) default is ordinarily the product of forces beyond a debtor's control. 49 Fed. Reg. at 7744. The Commission identified a confluence of factors which create "an obstacle to the free exercise of consumer decisionmaking" and which creditors are able to use to their advantage.

First, the Commission found that most creditors rely on standardized form contracts with boilerplate provisions defining the rights and duties of the parties. *Id.* at 7745-47. The Presiding Officer's Report concludes:

> Creditors universally make use of standardized forms in extending credit to consumers. These forms are prepared for creditors or obtained by them, and the completed contract is presented to the prospective borrower on a "take it or leave it" basis. The primary reason for this is simply that it is not feasible to conduct the transaction in any other way.

P.O. Report, J.A. at 395. The Commission acknowledges that standard form contracts are a business necessity for small-loan creditors. 49 Fed. Reg. at 7744. The Commission further found, however, that due to certain characteristics of the consumer credit market, it could not reasonably conclude that the mix of remedies included in the contracts reflects consumer preferences. *Id.* at 7744, 7746. Whereas consumers may bargain over terms such

as interest rates, and the amount or number of payments, their ability and incentive to bargain over the boilerplate remedial provisions is substantially limited. *Id.* at 7746-47.

Several aspects of the credit transaction combine to prevent consumers from making meaningful efforts to search, compare, and bargain over remedial provisions. As noted, standard form contracts are presented on a take it or leave it basis. While there are differences in the kinds of contracts offered by different creditors, certain creditors, namely finance companies serving higher-risk borrowers, are most likely to include HHG security interests and wage assignments. Furthermore while the incidence of use of these provisions may differ across different regions of the country, contracts offered by creditors of a given class in local areas are often substantially identical. *Id.* at 7746. Given the substantial similarity of contracts, consumers have little ability or incentive to shop for a better contract.

Consumers' ability to shop and bargain is further constricted by the fine print and technical language used in the contracts. *Id.* at 7747. Moreover, consumers are limited in their ability to seek explanations from lenders since inquiries about remedies are likely to make creditors wary and hesitant to grant a loan. Finally, "[i]n some cases, comparison is impossible because the creditor refuses to give out the loan contract until the borrower seems ready to sign it." *Id.*[24]

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[24] Contrary to the dissent's assertion, discussion of the use of standard form contracts and fine print is *not* "empty rhetoric" simply because no deception is involved or because the Commission found that additional information would not alter the consumer's choice. *See* Dissent at 6; *see also infra* pp. 37, 60. As the discussion in the text illustrates, the Commission relies on these attributes of the contracts as contributing factors in its overall analysis of the characteristics of the consumer credit market which limit consumers'

Consumers' limited ability and incentive to search out better contracts is compounded by creditors' lack of incentive to advertise or compete on the basis of remedies. *Id.* Consumers' lack of understanding of contractual terms is the first obstacle. Before competing on the basis of exclusion or inclusion of particular contract terms, creditors would have to educate the consumer as to the ramifications of the inclusion of a particular clause and why a contract excluding the clause is preferable. Such an educational effort would entail substantial costs and would tend to create a free-rider problem with competing creditors reaping benefits from the advertising creditor's educational efforts. The second disincentive to creditors is the problem of adverse selection. If a creditor advertised less onerous remedies, the creditor is likely to attract a disproportionately greater share of those debtors who intend to or who are most likely to default.

The Commission also relied upon the fact that default is a relatively infrequent occurrence and generally not within consumers' control. *Id.* at 7747-48. Consumers could avoid the injuries attendant on the use of HHG security interests and wage assignments if they avoided defaulting on their payments. Relying principally on two large complementary survey studies [25] of the causes of default, the Commission concluded that default is ordinarily the product of forces beyond the debtor's control. Default is usually precipitated by unforeseeable and unavoidable events that reduce income (*e.g.*, job loss or

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incentive and ability to bargain over remedial provisions and creditors' ability to compete on the basis of such terms.

[25] One study by the National Commission on Consumer Finance, *see* NCCF Technical Study, Vol. V. (1972), relied on survey data from creditors. The other study relied on survey data from debtors. *See* D. Caplovitz, Consumers in Trouble: A Study of Debtors in Default (1974). For a discussion of the results of the two studies, see Staff Report, J.A. at 786-802.

pay reduction) or increase demands (*e.g.*, incapacitation, relocation, unplanned emergency expenses, marital separation or divorce). When these events, outside the debtor's immediate control, occur default is generally an involuntary response.[26] *Id.* at 7747. The unforeseeable and unavoidable nature of default not only make the implementation of the creditor remedies unavoidable but also limit consumers' incentive to search for contracts which do not include particular remedies. Since consumers do not expect to default, the invocation of particular creditor remedies seems remote and speculative at the time of contracting and thus is not a material element in the consumer's decision. Instead consumers quite reasonably focus their attention on the more immediate terms such as interest rates and payments. *Id.* at 7746.

On the basis of the foregoing analysis, the Commission concluded that consumers cannot reasonably avoid the inclusion of HHG security interests and wage assignments in credit contracts or their implementation. We conclude that the Commission's finding of unavoidable injury comports with the criteria set out in the Commission's Policy Statement.

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[26] Petitioner AFSA argues that default is an infrequent occurrence and that not all debtors experiencing these adversities default, therefore, the debtors who default in such circumstances, could avoid default through better planning and the taking of precautionary measures. AFSA Brief at 40-41. The Commission addressed this issue and concluded that while "[p]recautions can reduce the risk of default . . . no reasonable level of precautions can eliminate the risk." 49 Fed. Reg. at 7748. Moreover, consumers have differential capacities to take precautions and default in any individual situation is likely to depend on the mix of circumstances at that point in time (*e.g.*, the consumer's level of debt, the number and type of adverse events occurring at once, benefits available, amount of savings or other assets available, presence of support from other family members). *See* FTC Brief at 27. In light of these considerations, we find petitioners' argument unpersuasive.

D. *Challenge to the FTC's Exercise of Unfairness Authority Under Section 5(a)*

Although the Commission has identified a substantial consumer injury, which is not offset by countervailing benefits, and which cannot be reasonably avoided by consumers, petitioners nonetheless challenge the ban on HHG security interests and wage assignments as outside the scope of the Commission's unfairness authority. Petitioners claim that the FTC's description of what constitutes a substantial, unjustified, and unavoidable injury in this proceeding exceeds the bounds the Commission itself has previously erected for channeling its discretion to proscribe unfair practices. *See* AFSA Brief at 17. With respect to "injury," petitioners assert that section 5 does not encompass consumer harms resulting from the consumer's own choice of action unless that choice is improperly manipulated by seller overreaching (*i.e.*, deception, coercion, or withholding of material information). Relatedly petitioners argue that the requirement of "unavoidability" is not met unless the seller's overreaching interferes with the consumer's ability to make an informed, uncoerced choice. Finding no creditor overreaching in the present case, petitioners assert that the FTC is attempting to play "national nanny" by protecting consumers against the hardships of their own miscalculations in pledging HHG security interests and wage assignments. *See* AFSA Brief at 62. In petitioners' view the FTC is gratuitously intervening in the market to provide the optimal mix of options for consumers. This exceeds the FTC's authority, in petitioners' view, because the FTC must first identify some overreaching creditor or seller practice which is distorting the proper functioning of the market.

In essence, petitioners ask the court to limit the FTC's exercise of its unfairness authority to situations involving deception, coercion, or withholding of material information. As noted earlier, despite considerable contro-

versy over the bounds of the FTC's authority, neither Congress nor the FTC has seen fit to delineate the specific "kinds" of practices which will be deemed unfair within the meaning of section 5. Instead the FTC has adhered to its established convention, envisioned by Congress, of developing and refining its unfair practice criteria on a progressive, incremental basis. Nevertheless, petitioners seek to support their claim that the FTC has exceeded its statutory authority by arguing that the Commission has never before asserted the scope of authority exercised in this rulemaking. Thus, in addressing petitioners' challenge, we look first to past Commission unfairness decisions to determine if a basis in precedent exists for the Commission's present rulemaking.

Our task of reviewing Commission unfairness precedent is hindered by the Commission's cautious use of its unfairness authority as an independent basis for decision—most frequently the Commission has relied on alternate theories of deception and unfairnes. *See supra* note 15. The Credit Practices Rule is a rare example of the Commission proceeding solely on unfairness grounds. We are aided, initially, by a fairly recent article authored by a member of the Commission's Office of Planning cataloguing the "kinds" of commercial practices which the Commission has determined to be unfair. Specifically this article identifies four primary categories of practices which have been prohibited as unfair: (1) withholding material information; (2) making unsubstantiated advertising claims; (3) using high-pressure sales techniques; and (4) depriving consumers of various post-purchase remedies. *See* Craswell, *supra* note 15, at 109.

It is true that many, *but not all*, of the Commission's unfairness decisions have involved the kind of overreaching seller conduct pinpointed by petitioners.[27] But of

[27] "Sometimes consumer unfairness is found even without coercion or denials of product information. A striking example arose in the early 1970's when a company began pro-

particular relevance to this case are those Commission decisions dealing with the allocation of post-purchase rights. The majority of consumer transactions involve not only the purchase of a product but also the alloca-

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moting razor blades in a way that risked serious injury to small children. Free samples of the blades were included indiscriminately in advertising supplements to home-delivered newspapers . . . . The Commission was able to use its unfairness jurisdiction to negotiate a consent decree barring this unsafe marketing technique [, *see* Philip Morris, Inc., 82 F.T.C. 16 (1973)]." Companion Statement on the Commission's Consumer Unfair Jurisdiction (accompanying 1980 Policy Statement), *reprinted in* H.R. Rep. No. 156, Pt. 1, 98th Cong., 1st Sess. 41, 42 (1983); *see also R.F. Keppel & Bro.*, 291 U.S. 304 (unfair practice to use gambling a lottery marketing technique to sell candy, *see* discussion *supra* p. 12.

We note, moreover, that there is no bright line definition of what constitutes a coercive practice. Coercive seller practices deemed unfair have generally involved situations where the seller's conduct prevents the consumer from making a free, informed choice. *See* Arthur Murray Studio, Inc. v. FTC, 458 F.2d 622 (5th Cir. 1972) (unfair for dance studio to use "cajolery" and other high pressure techniques aimed at enticing elderly women to enter contracts for extended series of dance lessons costing thousands of dollars); Holland Furnace Co. v. FTC, 295 F.2d 302 (7th Cir. 1961) (unfair for salesman to dismantle home furnaces for cleaning and inspection and then refuse to reassemble them until customer agreed to buy additional parts and services.); *see also* Cooling-Off Period for Door-to-Door Sales, 16 C.F.R. pt. 429 (1984) (providing for 3-day cooling-off period during which consumer can cancel a contract entered with a door-to-door salesperson). The present case may arguably entail an element of coercion. Consumers in serious financial need of a loan are presented with contracts containing HHG security interests and wage assignments on a "take it or leave it" basis with no apparent alternatives available. *Cf. infra* p. 49 (discussing FTC's opinion that the use of HHG security interests has many of the attributes of economic duress).

Furthemore, petitioners overlook critical aspects of unfairness decisions purportedly involving seller overreaching, which

tion, between the buyer and seller, of a number of contractual and noncontractual rights and duties with respect to the product purchased (*e.g.*, remedies available to the buyer if the product is defective or to the seller

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undercut their basic premises. For example, the petitioners assert that there is no precedent for the Commission to intervene in the market to produce a better mix of options in the absence of some identified seller practice which is distorting the proper functioning of the market. However, with respect to finding the withholding of material information or unsubstantiation of advertising claims unfair one might ask why in the absence of deception, should not the market be allowed to determine the optimal level of information? Yet the Commission has on a number of occasions promulgated rules requiring sellers to disclose "essential" information. *See, e.g.*, Care Labeling of Textile Wearing Apparel, 16 C.F.R. pt. 423 (1984) (requiring clothes to include labels giving washing instructions); Labeling and Advertising of Home Insulation, 16 C.F.R. pt. 460 (1984) (requiring disclosure of the R-value of insulation); Octane Posting and Certification, 16 C.F.R. pt. 306 (1984) (requiring the posting of octane levels). Petitioners' argument fails to distinguish between unfair practices and deceptive practices. A comparative review of various types of unfairness cases is complicated by the fact that most were brought on a deception theory and found to be deceptive as well as unfair. Hence the distinction between the deception rationale and the unfairness rationale tends to become obfuscated. Nonetheless the two rationales are distinct: A practice is deceptive when the consumer is forced to bear a larger risk than expected (*e.g.*, the consumer is misled) whereas a practice is unfair when the consumer is forced to bear a larger risk than an efficient market would require. *See generally* Craswell, *supra* note 15, at 125. The substantiation of advertising claim cases are illustrative. The FTC has determined that advertisers must have a "reasonableness basis" for making a claim and that making unsubstantiated advertising claims may be both an unfair and a deceptive practice. Unsubstantiated claims are unfair because consumers are forced to bear the risk that the claim will turn out to be false (and verification of the claim by the consumer would generally entail disproportionate costs to verification by the advertiser); unsubstantiated claims are deceptive because consumers expect that the advertiser has some basis for making the claim. *See, e.g., In re* Pfizer, Inc., 81 F.T.C. 23, 58-65 (1972); *In re*

if the buyer defaults). The Commission, in the post-purchase right cases, has stepped in to correct allocations of post-purchase remedies determined to be unfair to consumers.

A prime example is the Commission's rule preventing sellers from taking advantage of the holder-in-due-course doctrine. *See* Preservation of Consumers' Claims and Defenses, Statement of Basis and Purpose, 40 Fed. Reg. 53,506 (1975) (codified at 16 C.F.R. pt. 433 (1984)). The holder-in-due-course doctrine immunizes the subsequent holder of a negotiable instrument from the claims or defenses which the consumer could have asserted against the original holder, if the subsequent holder took the instrument for value, in good faith, and without notice of any claims or defenses against it. Thus, under the holder-in-due-course doctrine, the seller could discount the consumer's note to a third party making the consumer unconditionally liable to the third party with no recourse even if the product turned out to be totally defective. The Commission determined that the use of the holder-in-due-course doctrine in consumer credit transactions was an unfair practice. *See id.* at 53,524 ("[I]t constitutes an unfair and deceptive practice to use contractual boilerplate to separate a buyer's duty to pay from a seller's duty to perform."). The Holder-in-Due-Course Rule abrogated the use of the holder-in-due-course doctrine in consumer credit transactions by requiring sellers to include a notice in all consumer sales instruments stating that any subsequent holder is subject to all claims and defenses that could be asserted against the seller.

Firestone Tire & Rubber Co., 81 F.T.C. 398, 451 (1972), *aff'd*, 481 F.2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973). *See also In re* Porter & Dietsch, Inc., 90 F.T.C. 770, 866 & n.11 (1977) (the "reasonable basis" standard for evaluating the substantiating material is the same whether advertisement is analyzed under a theory of deception or a theory of unfairness), *aff'd in relevant part*, 605 F.2d 294 (7th Cir. 1979), *cert. denied*, 445 U.S. 950 (1980); *In re* National Dynamics Corp., 82 F.T.C. 488, 550 n.10 (1973) (same).

Petitioners distinguish the Holder-in-Due-Course Rule, by asserting that there the Commission intervened "to prevent consumers from being victimized by a counter-intuitive legal doctrine." AFSA Brief at 31 n.3. Petitioners thus attempt to characterize the rationale underlying the Holder-in-Due-Course Rule solely in terms of deception. We find this argument unpersuasive in light of the Commission's stated rationale. Prior to promulgating the Holder-in-Due-Course Rule, the Commission had already held a seller's practice of routinely assigning purchasers' notes to third parties inherently unfair and deceptive because consumers were unaware and did not intuitively expect that a seller could deprive them of valid claims and defenses to the obligation by discounting their notes to third parties. Disclosure was determined to be the proper remedy. *See* In re *All-State Industries, Inc.*, 75 F.T.C. 465, 489-94 (1969), *aff'd* 423 F.2d 423 (4th Cir.), *cert. denied*, 400 U.S. 828 (1970). The Commission, however, adopted a more econonmically oriented rationale focusing on the effect of the seller's post-purchase conduct on the consumer's economic welfare when it later adopted the Holder-in-Due-Course Rule which completely prevented sellers from taking advantage of the holder-in-due course doctrine. *See* Preservation of Consumers' Claims and Defenses, Statement of Basis and Purpose, 40 Fed. Reg. at 53,522-24.

> The Commission believes that relief under Section five of the FTC Act is appropriate where sellers or creditors impose adhesive contracts upon consumers, where such contracts contain terms which injure consumers, and where consumer injury is not off-set by a reasonable measure of value received in return. In this connection, the Commission's authority to examine and prohibit unfair practices in or affecting commerce in the manner of a commercial equity court is appropriately applied to this problem. Where one party to a transaction enjoys sub-

> stantial advantages with respect to the consumers with whom he deals, it is appropriate for the Commission to conduct an inquiry to determine whether the dominant party is using an overabundance of market power, or commercial advantage, in an inequitable manner.

Id. at 53,524.

Thus the Commission in promulgating the Holder-in-Due-Course Rule articulated an economic rationale for its unfairness determination.

> This theory (in effect) posits a market imperfection which for some reason prevents the market from arriving at the most efficient distribution of post-purchase rights between buyers and sellers. Faced with such an imperfection, the Commission steps in to correct the market's results by reassigning post-purchase rights between the various parties until the most efficient result is reached.

Craswell, *supra* note 15, at 131. This is basically the same economic rationale exemplified in the Commission's Policy Statement and utilized in this case. *See* Policy Statement at 37 (Commission's actions are brought "to halt some form of seller behavior that unreasonably *creates* or *takes advantage* of an obstacle to the free exercise of consumer decisionmaking") (emphasis added). Thus contrary to petitioners' assertions, the Commission has in the past sanctioned intervention not only where the seller's conduct affirmatively causes distortion of proper market functioning but also where the seller takes advantage of an existing obstacle which prevents free consumer choice from effectuating a self-correcting market.

In the present case, the Commission identified particular aspects of the credit transaction which substantially limit the consumer's ability and incentive to bargain over credit remedies and which limit the creditor's incentives to compete on the basis of remedies. *See supra*

pp. 33-37. This market imperfection prevents consumer choice from operating to effect the mix of remedies which most reflects consumer preferences and leaves creditors free to exploit this market failure by including an entire litany of remedies as boilerplate provisions.[28] Thus the Commission concluded that by insisting on HHG security interests and wage assignments, creditors are taking advantage of an existing obstacle to the free exercise of consumer decisionmaking and thereby engaging in an unfair practice.

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[28] In the present case the contract terms in question are buried in fine print and only become operative upon the contingency of default. Analogously the Holder-in-Due Course Rule involved an aspect of contract law which did not appear on the face of the contract and which only became relevant if the seller discounted the note to a third party. In other cases, the Commission has found an unfair practice where the contract did not prevent the seller from engaging in particular conduct. *See, e.g., In re* Spiegel, Inc., 86 F.T.C. 425 (1975) (unfair practice for Spiegel to bring lawsuits against out-of-state mail order customers in Cook County, Illinois), *aff'd in relevant part*, 540 F.2d 287 (7th Cir. 1976); *In re* Beneficial Finance Corp., 86 F.T.C. 119 (1975) (unfair practice for tax preparation firm to use confidential tax information about customers for commercial purposes without first obtaining a signed consent), *aff'd in relevant part*, 542 F.2d 611 (3d Cir. 1976), *cert. denied*, 430 U.S. 983 (1977).

The Commission has also on occasion required the inclusion of specific, substantive, noninformational terms in consumer contracts. *See* Use of Negative Option Plans by Sellers in Commerce, 16 C.F.R. pt. 425 (1984) (setting time limits within which sellers must ship merchandise and consumers must be allowed to return merchandise as well as requiring disclosure of how consumers can avoid acceptance of goods and whether billing charges include postage). Somewhat analogously the Commission's rule requiring that consumers be given a three day cooling-off period following a purchase from a door-to-door salesman mandates that an additional substantive term be included in the agreement. *See* Cooling-Off Period for Door-to-Door Sales, 16 C.F.R. pt. 429 (1984).

While we agree with petitioners that the Commission cannot be allowed to intervene at will whenever it believes the market is not producing the "best deal" for consumers, we nonetheless believe that this court would be overstepping its authority if we were to mandate, as petitioners urge, that the Commission's unfairness authority is limited solely to the regulation of conduct involving deception, coercion or the withholding of material information. As previously discussed, the Commission's consumer injury test, set forth in its Policy Statement, while not specifically defining the "kinds" of practices or injuries encompassed, is the most precise definition of unfairness articulated to date by either the Commission or Congress. Upon reviewing it, Congress has not seen fit to enact any more particularized definition of unfairness to limit the Commission's discretion. Indeed, the most significant congressional response to the Policy Statement has not been criticisms or rejection, but proposals to enact the Commission's three-part consumer injury standard into law. *See supra* pp. 20-22 & n.14. Thus, the Commission has, for all practical purposes, been left to develop its unfairness doctrine on an incremental, evolutionary basis. *See supra* p. 15. At this juncture, it is not for this court to step in and confine, by judicial fiat, the Commission's unfairness authority to acts or practices found to be deceptive or coercive. Our role is simply to review the Commission's exercise of its unfairness authority in this case. *See supra* pp. 16-18. We find that the Commission's articulated rationale for its determination that the taking of HHG security interests and wage assignments constitute unfair practices fully comports with the criteria set out in the FTC's Policy Statement. The Commission has sufficiently identified and documented the factors resulting in an obstacle to free consumer decisionmaking which is being exploited by creditors to the detriment of consumers.[29] We cannot

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[29] The dissent claims that the Commission cannot intervene "when it does not know the 'obstacle to free choice.'" *See*

therefore say that the Commission has exceeded the boundaries of its statutory authority to define unfair practices in this case.

The Commission's economic rationale for finding the taking of HHG security interests and wage assignments to be unfair practices is additionally bolstered by considerations of equity and public policy. It is well established that certain types of contracts or contractual provisions may be prohibited simply because they violate accepted principles of fair play and equity, *e.g.*, contracts of adhesion. *Cf.* U.S.C. § 2-302 (1978) (unconscionable contracts or clauses). And courts have recognized that the Commission was never intended to disregard principles of equity in reaching its decisions. *See Sperry & Hutchinson*, 405 U.S. at 244 (FTC may "like a court

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Dissent at 7. As the foregoing discussion illustrates, however, this is not a case where the Commission failed to articulate and document the factors resulting in an obstacle to free consumer choice. The dissent simply chooses to disregard the Commission's comprehensive analysis of the confluence of factors which create an obstacle to free consumer choice and a self-correcting market. Instead, the dissent places principal reliance on the fact that HHG security interests and wage assignments are used primarily by finance companies dealing with lower-income, higher risk borrowers, whereas higher-income, creditworthy consumers may obtain credit without these onerous provisions. Thus while the dissent acknowledges that an obstacle to the free exercise of consumer decision-making does exist for the lower-income, higher-risk consumer, it finds this justified by the higher risk level of these borrowers and consequently not evidence of a market failure. But the fact that the Commission's analysis applies predominantly to certain creditors dealing with a certain class of consumers (lower-income, higher-risk borrowers) does not, as the dissent suggests, undercut its validity. The Commission has identified a market failure with respect to a particular category of credit transactions which is being exploited by the creditors involved to the detriment of the consumers involved, and thus the dissent's argument that higher-income, more creditworthy consumers can obtain credit on better terms from banks is unavailing.

of equity" consider "public values beyond those enshrined in the letter or . . . spirit of the antitrust laws"); *FTC* v. *Standard Educ. Soc'y*, 86 F.2d 692, 696 (2d Cir. 1936) (Hand, J.) (FTC's "duty in part at any rate, is to discover and make explicit those unexpressed standards of fair dealing which the conscience of the community may progressively develop"), *rev'd on other grounds*, 302 U.S. 112 (1937) (reversing that part of Second Circuit's holding which modified and weakened FTC's cease and desist order); *see also Spiegel, Inc.* v. *FTC*, 540 F.2d 287, 292 (7th Cir. 1976) (invoking a public policy rationale and stating that FTC has "authority to prohibit conduct that, although legally proper, [is] unfair to the public"). In its Policy Statement, the Commission states that considerations of public policy are frequently used as confirmatory evidence of the unfairness of a particular practice but that "[s]ometimes public policy will independently support a Commission action." Policy Statement at 38-39. *See generally* Averitt, *supra* note 15, at 275-78 (discussing FTC's reliance on public policy considerations); Craswell, *supra* note 15, at 135-39 (discusing FTC's reliance on considerations of equity).

In the present case, the Commission found that wage assignments are prohibited in Uniform Credit Code states, several other states, and the District of Columbia. 49 Fed. Reg. at 7756. The substantial majority of states permitting wage assignments impose restrictions on their use. *Id.* Similarly, several states prohibit the taking of non-possessory, non-purchase security interests in household goods, and others place limitations on their use. *Id.* at 7781-82 & n.10. Both the NCCF study and the Creditor Remedies Project, which provided the impetus for the Commission's rulemaking, *see supra* pp. 3-4, delineated the creditor abuses and concomitant consumer injuries entailed in the use of HHG security interests and wage assignments, and recommended that the use of these creditor remedies be substantially restricted or

eliminated. In addition, the Commission stated its opinion that:

> [T]he use of blanket security interests to exhort an overextended or unemployed consumer to make a decision which may lead to increased financial difficulties has many of the attributes of economic duress. Threats to seize the personal possessions of a consumer and his or her family clearly meet many of the criteria for economic duress, especially given the dire financial circumstances in which the consumer finds himself. Although the Commission has premised its findings regarding the unfairness of threats to seize household goods on the resulting psychological and economic injury to consumers, as demonstrated by information contained in the rulemaking record, these common law doctrines provide evidence of public policy supporting the Commission's findings.

49 Fed. Reg. at 7765 (footnotes omitted). Thus the Commission's exercise of its unfairness authority in proscribing the use of HHG security interests and wage assignments can be fairly viewed as falling within the Commission's authority to take into consideration principles of equity and public policy and to proscribe acts or practices found to violate those principles.

E. *Challenge to FTC's Rulemaking Authority Under Section 18(a)*

Section 18(a)(1)(B) of the FTC Act empowers the Commission to prescribe "rules which define with specificity acts or practices which are unfair or deceptive acts or practices" and to "include requirements prescribed for the purpose of preventing such acts or practices." Petitioners claim that by branding the very taking of a security interest in household goods or an assignment of future wages as unfair practices, the FTC has not defined with specificity any unfair practice but has merely prescribed a requirement for preventing unfair

practices. *See* AFSA Brief at 55. The petitioners' argument is predicated on the Second Circuit's holding in *Katharine Gibbs School (Inc.)* v. *FTC*, 612 F.2d 658 (2d Cir. 1979). In *Katharine Gibbs*, the Second Circuit set aside the Commission's "Vocational Schools Rule" because "[i]nstead of defining with specificity those acts or practices which it found to be unfair or deceptive, the Commission contented itself with treating violations of its 'requirements prescribed for the purpose of preventing' unfair practices as themselves the unfair practices." *Id.* at 662. The court held that the rule must define specific unfair practices; the unfair practices cannot be defined in terms of future violations of the rule's remedial requirements. Even if this court were to adopt the Second Circuit's view of section 18(a) expressed in *Katharine Gibbs*, we would still find it inapplicable to the present case.[30]

In promulgating the Vocational Schools Rule at issue in *Katharine Gibbs*, the FTC was concerned about "unfair and deceptive advertising, sales, and enrollment practices engaged in by some of the schools." *Id.* at 661. However, rather than defining the specific advertising, sales, and enrollment practices deemed unfair, the FTC adopted a rule regulating tuition refund policies. The rationale behind the rule was to alter the incentive structure for obtaining enrollments by making it financially burdensome for a school to accept any student who was unlikely to complete the course for any reason. *Id.* at 663. "Although the Commission did not fault existing refund policies, it provided, nonetheless, that any failure to comply with its newly prescribed refund obligations

[30] We note that *Katharine Gibbs* was the first case to decide the lawfulness of a rule promulgated under section 18 and the decision was not without controversy. *See Katharine Gibbs*, 612 F.2d at 671-76 (Newman, J., dissenting); Katharine Gibbs School (Inc.) v. FTC, 628 F.2d 755 (2d Cir. 1980) (Oakes, J., dissenting from denial of petition for rehearing en banc) (joined by Mansfield, J. and Newman, J.).

would constitute an unfair or deceptive act or practice in connection with the sale or promotion of a course." *Id.* The FTC's rule, thus, penalized every vocational school for every dropout regardless of cause, leading the Second Circuit to conclude that there was no rational connection between the prescribed, universally applicable refund provisions and the prevention of specific unfair enrollment practices.[31]

The provisions of the Credit Practices Rule at issue in this case are clearly distinguishable from the provisions of the Vocational Schools Rule set aside in *Katharine Gibbs*. The prescribed refund requirements of the Vocational Schools Rule were designed to prevent unrelated, unspecified unfair enrollment advertising and sales practices. In contrast, the Credit Practices Rule identifies specific practices, namely the taking of HHG security interests and wage assignments as collateral, as *per se* unfair and prohibits those practices.[32] *See* 49 Fed. Reg. at 7745 ("The rule defines the use of such clauses or procedures, *in se*, to be an unfair practice."). We agree with the Commission that "[b]ecause . . . the direct relationship between the unfair practice and the proscription of that practice is apparent on the face of each . . . provision, there is no reason to set out the two separately." *Id.* The Commission having defined with

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[31] The petitioners also rely on *Katharine Gibbs* to support their argument that the ban on the use of HHG security interests and wage assignments as collateral is an overly broad remedy lacking a rational connection to the practices deemed unfair. This argument is addressed *infra* at Part III-C.

[32] Petitioner AFSA, in its Reply Brief, argues that the FTC is attempting to circumvent the requirements set out in *Katharine Gibbs* by characterizing the Rule as a restriction on creditor remedies whereas really the Rule is a restriction on consumers' ability to give collateral. We find this semantic quibbling unpersuasive. The FTC has identified particular contractual creditor remedies, however characterized, as unfair practices and thus prohibited their use.

specificity the acts or practices deemed unfair has fully complied with the statutory requirements of section 18(a)(1)(B).

III. Substantial Evidence and Breadth of Remedy

Petitioners contend that even if the Credit Practices Rule's ban on HHG security interests and wage assignments represents a permissible application of the three-part consumer injury standard within the Commission's statutory authority, the challenged provisions must still be set aside as arbitrary and capricious agency action. Petitioners argue that the Commission's conclusions are not supported by substantial evidence in the record and that the prohibition is an overly broad means of preventing the consumer injuries identified.

A. *Scope of Judicial Review*

This court may set aside the Commission's action only if it "is not supported by substantial evidence in the rulemaking record," *see* 15 U.S.C. § 57a(e)(3),[33] or if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law . . . ." *Id.* (incorporating 5 U.S.C. § 706(2)(A) standard). The legislative history of the Magnuson-Moss Act further provides that the substantial evidence standard is to be applied only to the Commission's "factual determinations"; the arbitrary or

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[33] The statement of basis and purpose for a rule is defined in the statute as part of the "rulemaking record" which is subject to judicial review, *see* 15 U.S.C. § 57a(e)(1)(B), yet 15 U.S.C. § 57a(e)(5)(C) states that the contents and adequacy of the statement of basis and purpose "shall not be subject to judicial review in any respect." This court resolved this statutory anomaly in *American Optometric Ass'n*, 626 F.2d at 906, by stating that the court will consult the statement of basis and purpose where it is "helpful in understanding the Commission's reasoning, but, nevertheless, being careful not to impose upon the statement the unreasonable demands about which Congress was concerned [*i.e.*, requiring voluminous and detailed statements]." *Id.*

capricious standard is to be applied to all other determinations. *See American Optometric Ass'n*, 626 F.2d at 904 (setting forth scope of judicial review under FTC Act of a trade regulation rule). A factual finding is supported by substantial evidence if the record contains "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." *American Textile Mfrs. Inst., Inc.* v. *Donovan*, 452 U.S. 490, 522 (1981) (quoting *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 477 (1951)). To decide whether an agency's action is arbitrary or capricious, "the court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Citizens to Preserve Overton Park* v. *Volpe*, 401 U.S. 402, 416 (1971). "This 'arbitrary and capricious' standard of review is a highly deferential one, which presumes the agency's actions to be valid." *Environmental Defense Fund, Inc.* v. *Costle*, 657 F.2d 275, 283 (D.C. Cir. 1981) (citations omitted). Contrary to the dissent's approach, this standard "forbids the court's substituting its judgment for that of the agency, and requires affirmance if a rational basis exists for the agency's decision." *Ethyl Corp.* v. *EPA*, 541 F.2d 1, 34 (D.C. Cir.) (en banc) (citations omitted), *cert. denied*, 426 U.S. 941 (1976).

B. *Substantial Evidence*

The Credit Practices Rule, as previously discussed, was adopted after a nine-year rulemaking period in which an extensive record was developed and each provision of the Rule painstakingly considered. *See supra* pp. 4-7 & nn. 2-4. The Commission has presented detailed documentation of the record evidence relied upon to support each of its conclusions. *See* 49 Fed. Reg. 7745-48, 7755-68. The Commission's documentation is amply sufficient and we find no need to duplicate or supplement that documentation with our own recitation of the record evidence supporting each of the Commission's findings and conclu-

sions.[34] Thus we address only the principal challenges to the sufficiency of the evidence raised by petitioners.

First, petitioner AFSA questions the sufficiency and reliability of the "anecdotal" evidence supplied by legal aid attorneys or consumer legal specialists who attested to the consumer injuries resulting from the use of HHG security interests and wage assignments. *See* AFSA Brief at 52-55. Specifically AFSA relies on "reservations" about the attorneys' testimony expressed by the Presiding Officer. *See* AFSA Brief at 53 n.2. AFSA, however, disregards the Presiding Officer's final conclusion:

> [The attorneys] testimony was truthful and provided credible evidence of the injuries suffered by their clients in the consumer credit marketplace. Indeed, it would be difficult to identify a better source for such evidence.

P.O. Report, Appendix at 687. Furthermore, as the FTC points out, it relied on not only a large number of "anecdotes" from consumer law specialists, but also on other corroborating studies and materials. *See* FTC Brief at 24 n.17; *see also supra* note 19.

Petitioners also contend that the record does not support the Commission's conclusion that the injuries entailed in the use of HHG security interests and wage assignments outweigh any benefits the availability of such clauses may provide consumers. Specifically, petitioners argue that the FTC did not find, and could not find on the basis of the record evidence, that the proscription on the use of household goods and wage assignments would not diminish the availability of credit or increase its cost for those consumers whose access previously depended on their ability to pledge household goods and

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[34] The court has already cited to various portions of the record evidence in Part II-C discussing the Commission's application of its three-part consumer injury standard.

wage assignments as collateral. *See* AFSA Brief at 42. Petitioners fault the Commission for accepting the conclusions of the rulemaking staff that the Rule would only marginally affect the cost and availability of credit over the contrary views of the FTC's Bureau of Economics and Bureau of Consumer Protection. *See* AFSA Brief at 47. In sum, petitioners claim that the Commission's cost-benefit approach was inadequate and that this inadequacy had been brought to the Commission's attention by two of its own bureaus.[35]

Petitioners' argument harbors a fundamental misconception about the nature of the Commission's required cost-benefit analysis. Petitioners would require that the Commission's predictions or conclusions be based on a rigorous, quantitative economic analysis. There is, however, no basis for imposing such a requirement.

In its 1982 Policy Letter, the Commission stated its view of the required cost-benefit analysis:

> As to the element pertaining to the weighing of benefits and costs, however, the Commission believes there is an associated problem to consider, namely the risk that the analysis might unnecessarily complicate and delay an investigation or an ultimate litigation. For this reason, the Commission believes that a highly quantitative benefit/cost analysis may not be appropriate in each and every individual case, and that in some cases a far more subjective analysis would be the reasonable approach.

1982 Policy Letter, *supra* note 18, at 33.

Analogously the Magnuson-Moss Act, establishing the Commission's rulemaking authority, requires the Commission to include a statement of a rule's economic im-

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[35] Petitioners also cite the Presiding Officer's observation that the ban on the use of HHG security interests may have "far-reaching" effects. The flaw in this argument is addressed *infra* p. 60.

pact in the statement of basis and purpose. 15 U.S.C. 57a(d)(1). Congress, however, explicitly expressed its intent that this requirement not place excessively strict burdens on the Commission.

> In particular, the requirement that the statement include statements as to the economic impact of the rule does not require the Commission to undertake a full scale economic investigation prior to promulgation of the rule. To do this would inordinately delay FTC proceedings and deny relief to the consuming public while indefinite questions of economic prediction were resolved by the Commission. This provision should be read to require that the Commission consider the economic impact of the rule to issues and summarize its best estimate of that impact in the statement. Obviously, a full evaluation of the economic impact of the rule would have to await its implementation.

H.R. Rep. No. 1107, 93d Cong., 2d Sess. 47 (1974).

In addition to rejecting petitioners' view of the standard to which the Commission's cost-benefit analysis should be held, we also find petitioners' specific contentions of error unpersuasive. Most of petitioners' cost estimates are based on their own self-serving predictions that finance companies will restrict the availability and increase the cost of credit as a result of the Commission's Rule. Memoranda from the FTC's Bureaus of Economics and Consumer Protection form the primary basis of support in the record for petitioners' arguments. *See* Bureau of Economics Final Recommendations, *supra* note 3; *see also* Muris Memorandum, Higgins Memorandum, and Gramm Memorandum, *supra* note 3.

The Bureau of Economics and Consumer Protection focus their criticism on the rulemaking staff's interpretation of the econometric evidence in the record.[38] However,

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[38] The econometric evidence in the record consisted of empirical studies examining the relationship between various

the econometric evidence in the record, by all accounts, contains deficiencies which prevent definitive answers. Thus it boils down to an issue of interpretation. The Division of Credit Practices put forth a strong argument supporting the staff's analysis and countering the interpretation proffered by the two Bureaus. *See* Memorandum to Commission from Christopher Keller, et al. (May 24, 1983), J.A. at 1933 [hereinafter cited as Keller Memorandum].

The Keller Memorandum points out that the Bureaus' counter-arguments are based primarily on abstract or or theoretical arguments about the operation of credit markets and the nature of consumer debtors which have little or no factual support in the record.[37] Keller Memorandum, J.A. at 1933. The Keller Memorandum also notes the Bureaus' exclusive focus on costs to the exclu-

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restrictions on creditor remedies and the cost and availability of credit by analyzing data from states which already have laws restricting various creditor remedies.

[37] The Bureau of Economics identified the three key functions of collateral as: compensation of creditors upon default; deterrence of default; and signalling. The Bureaus and petitioners assert that the Commission has overlooked the value of HHG security interests and wage assignments with respect to these functions. The Keller Memorandum, however, argues that evidence from other sources in the record refutes the theoretical bases of these arguments, *i.e.*, if default is involuntary then the theory of deterrence value is undercut; and if household goods have no resale value or a defaulter is fired when a wage assignment is exercised then the theory of compensation value is undercut. *See* Keller Memorandum, J.A. at 1934-35, 1949-51. With respect to signalling, whereby a debtor indicates the intention to repay by submitting to onerous creditor remedies in case of default, the Keller Memorandum points out that there is no empirical evidence in the record to support the validity of signalling theory. J.A. at 1937-38. The Bureau of Consumer Protection expressly states that signalling theory is new and not well established or researched with respect to its validity in consumer credit markets. *See* Muris Memorandum, *supra* note 3, J.A. at 1835.

sion of the Rule's benefits which are both pecuniary and non-pecuniary.[38] The non-pecuniary nature of many of the benefits makes them difficult to measure and weigh in cost-benefit terms. Keller Memorandum, J.A. at 1939-41.

On the basis of the record before us, we cannot say that the Commission's decision to reject the Bureaus' interpretations of the record evidence was unreasonable. Nor do we find the dissent's reassessment of the costs and benefits entailed by proscribing the use of HHG security interests and wage assignments persuasive. The dissent basically concludes, upon its own interpretation of the record, that the Commission "grossly exaggerates the beneficial impact of the Rule," *see* Dissent at 11, and underestimates the costs by failing to determine in absolute terms the number of consumers who will be denied credit as a result of the Rule. However, "the possibility of drawing two inconsistent conclusions from the evidence does not prevent an administrative agency's finding from being supported by substantial evidence." *Consolo* v. *Federal Maritime Comm'n*, 383 U.S. 607, 620 (1966). In our view, as indicated in our discussion of the nature of the cost-benefit analysis required of the Commission and the Commission's specific analysis in this rulemaking, *see supra* pp. 54-58 & nn. 35-38, the conclusions reached by the Commission with respect to the relative costs and benefits of proscribing the use of HHG security interests and wage assignments are supported

[38] The pecuniary benefits cited include: fewer costly refinancings; fewer deficiency balances and in lower amounts; less loss of equity in property; goods remaining in the hands of the party where they have the most value; and fewer delinquencies triggered by one creditor filing a wage assignment. The non-pecuniary benefits cited include: procedural due process protections; the opportunity to assert valid claims and defenses; less economic distress and disruption of family finances; less embarrassment, humiliation, and anxiety; less interference in employment relations; retention of personal and household goods; and protection against coerced settlements. *See* Keller Memorandum, J.A. at 1940.

by substantial evidence in the rulemaking record. *See National Ass'n of Regulatory Util. Comm'rs* v. *FCC*, 737 F2d 1095, 1140 (D.C. Cir. 1984) ("The fact that an agency's decision . . . rests on a set of evidentiary facts less desirable or complete than one which would exist in some regulatory utopia does not alter our role.").

C. *Breadth of Remedy*

Petitioners claim that the challenged provisions of the Credit Practices Rule sweep too broadly and that the Commission could have chosen alternate means more narrowly tailored to preventing the specific abuses identified.[39] Our review of the Commission's chosen remedy is quite limited.

> The Commission is the expert body to determine what remedy is necessary to eliminate the unfair or deceptive trade practices which have been disclosed. It has wide latitude for judgment and the courts will not interfere except where the remedy selected has no reasonable relation to the unlawful practices found to exist.

Jacob Siegel Co. v. *FTC*, 327 U.S. 608, 612-13 (1946). We find no abuse of discretion and no cause to interfere in the present case. The Commission reasonably concluded that the most effective way to eliminate the unfair practices of taking HHG security interests and wage assignments was to proscribe their use.

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[39] AFSA relies on *Katharine Gibbs* to support its argument that the Rule is invalid because it is not limited in scope to preventing the specific abuses at which it is aimed. We have already distinguished *Katharine Gibbs*, *see supra* p. 51; whereas in *Katharine Gibbs* the universally applicable remedial refund provisions were unrelated to the abusive enrollment techniques, here the unfair practice is the taking of HHG security interests and wage assignments and the remedy is a prohibition of their use.

The Commission considered narrower, alternative remedies but determined that such alternatives failed to address the full range of problems found inherent in the use of HHG security interests and wage assignments. For example, the Commission rejected a suggested alternative provision requiring only that creditors disclose in plain English the meaning of the contractual remedies. The Commission reasoned:

> [D]isclosure alternatives would deal only partially with limited seller incentives to promote alternative remedies . . . and would not address at all consumers' limited incentives to search for information about remedies.

49 Fed. Reg. at 7747. *See id.* at 7787-89 (discussing empirical evidence on the costs and benefits of the disclosure alternative).

Petitioner AFSA apparently seeks to bolster its overbreadth argument (and its cost-benefit argument) by citing to the Presiding Officer's observation that the prohibition of HHG security interests may have far-reaching effects. The Presiding Officer's observation, however, was with respect to the household goods provision as it was then drafted. The provision at that time did not contain the narrow definition of household goods that it now does. Thus the Presiding Officer found that "the rule would prohibit the granting of security interests in such broad categories of property as jewelry, expensive luxury items, and, depending upon the purpose of the loan, grants of security interests in real property and personal property not within the commonly accepted definition of household goods." P.O. Report, J.A. at 644. The Commission's inclusion of a precise, narrowly tailored definition of household goods in 16 C.F.R. § 444.1(i) addressed the concerns identified by the Presiding Officer.[40] *See* 49 Fed. Reg. at 7767-68.

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[40] AFSA argues that even under the definition of household goods adopted in 16 C.F.R. § 444.1(i), the Rule still prevents

In sum, following a careful review of the Commission's analysis of the record evidence, we find petitioners' challenges unpersuasive. The Commission's decision to proscribe the use of HHG security interests and wage assignments is supported by substantial evidence in the record and the Commission has neither acted arbitrarily or capriciously nor abused its discretion.

IV. Preemption of State Law

Petitioners AFSA and, in particular, SCDCA, claim that the FTC has exceeded its rulemaking authority by "preempting" or "supplanting" the "carefully wrought consumer protection statutes" of those states that either allow or regulate the use of HHG security interests and wage assignments. Although the Magnuson-Moss Act contains no explicit preemption provision, "[i]t has long since been firmly established that state statutes and regulations may be superseded by validly enacted regulations of federal agencies such as the FTC." *Katharine Gibbs*, 612 F.2d at 667 (citing *Free* v. *Bland*, 369 U.S. 663 (1962); *Spiegel, Inc.* v. *FTC*, 540 F.2d 287, 293 (7th Cir. 1976)). The legislative history of the Magnuson-Moss Act and predecessor bills[41] indicate that while

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consumers from pledging goods which cannot reasonably be deemed necessities such as Gucci shoes, furs, Edwardian breakfronts and Art Nouveau curio cabinets. *See* AFSA Brief at 23-27. On a practical level, however, we find that the Commission's definition is sufficiently narrow to apply principally to household and personal necessities.

[41] None of the House or Senate Reports accompanying the Magnuson-Moss Act speak directly to the issue of the intended preemptive effect of the Commission's trade regulation rules. House Report 1107 does, however, speak to preemption in its discussion of another provision of the amendment expanding the language of section 5 to "in or affecting commerce":

> The amendments made by 201 will permit more effective regulation of the marketplace by the FTC by placing

Congress did not intend the Commission's regulations to "occupy the field," it did intend FTC rules to have that preemptive effect which flows naturally from a repugnancy between the Commission's valid enactments and state laws. *See id.* at 667 (reaching the same conclusion); Verkuil, *supra* note 40, at 247 ("While the Commission was not given the authority to occupy the field of state unfair competition in consumer protection law, it was authorized to declare by rule preemption of state activities that conflict with regulations.").

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within its reach unfair or deceptive acts or practices which, although local in character, affect interstate commerce. The expansion of the FTC's jurisdiction made by this section 201 is not intended to occupy the field or in any way to preempt State or local agencies from carrying out consumer protection or other activities within their jurisdiction which are also within the expanded jurisdiction of the Commission.

Where cases of consumer fraud of a local nature which affect commerce are being effectively dealt with by State or local government agencies, it is the Committee's intent that the Federal Trade Commission should not intrude.

H.R. Rep. No. 1107, 93d Cong., 2d Sess. 45 (1974). Congress made clear that while it was expanding the FTC's jurisdiction, it did not intend for the FTC to occupy the field of consumer protection or to gratuitously intrude on state or local enforcement activities. Thus states' regulations are only supplanted when inadequate or counterproductive to the Commission's regulations.

Predecessor bills considered by Congress were more explicit with respect to outlining the Commission's intended preemption authority. *See, e.g.*, S. 3201, 91st Cong., 2d Sess. § 106 (1969) (including specific preemption for repugnancy provision), *reprinted in* S. Rep. No. 1124, 91st Cong., 2d Sess. (1970); S. Rep. No. 269, 92d Cong., 1st Sess. 28 (1971) ("In the course of the Committeee's consideration of the Commission's rulemaking power the issue of preemption was discussed. At the present time a Trade Regulation Rule would preempt state legislation or regulation that conflicted."). For a complete review of the legislative history with respect to preemption, see Verkuil, Preemption of State Law by the Federal Trade Commission, 1976 Duke L.J. 225.

In *Katharine Gibbs*, the Second Circuit found the preemption provisions of the Vocational Schools Rule overly broad and thus beyond the Commission's power. 612 F.2d at 667. The preemption provision of the Vocational Schools Rule decreed preemption of any state law or regulation which frustrated the purpose of the Rule's "inadequately spelled out provisions," *see supra* p. 50, thereby potentially preempting "an indefinite variety of state laws and regulations governing the contractual relations between vocational schools and their students." *Katherine Gibbs*, 612 F.2d at 667. The court noted that "[i]f the Commission had defined with specificity the acts or practices it deemed unfair or deceptive, questions of preemption could be answered with relatively little difficulty." *Id.* This court in *American Optometric Ass'n*, found that the Commission had "at least approached the outer boundaries of its authority where "the Commission's proposed pre-emption of state law [was] almost as thorough as human ingenuity could make it." 626 F.2d at 910. In *American Optometric*, the Commission proposed to preempt the whole field of ophthalmic advertising. These cases recognize only that Congress did not intend for the Commission's regulations "to occupy the field." Hence they do not support petitioners' challenge to preemption in this case, since the Commission has made explicit that "the rule is not intended to occupy the field of credit regulation or to preempt state law in the absence of requirements that are inconsistent with the rule." 49 Fed. Reg. at 7783.

In the Statement of Basis and Purpose for the Credit Practices Rule the Commission states:

> The rule has been drafted to be as consistent with existing state laws as possible. Indeed, state laws served as the model for several rule provisions. The rule prohibits practices that are authorized by statute or common law in at least some states. However, none of the rule provisions *preempts* state law by creating an irreconcilable conflict. That is, creditors

> will be able to comply with both state law and this rule.

Id. at 7782 (footnote omitted) (emphasis in original). The Commission further included in the Rule an exemption provision whereby states that offer protections equal to or greater than the Rule can obtain an exemption from the Rule. *See* 16 C.F.R. § 444.5. With respect to the weight to be given the exemption provision, the Fourth Circuit, upholding the FTC's authority to promulgate the Funeral Rule despite state regulation of funeral homes, noted:

> Furthermore, Congress explicitly considered this issue, and provided in Section 19(d) of the Federal Trade Commission Improvements Act of 1980 . . . that the existence of state regulation was no barrier to a funeral rule as long as the rule allowed any state to obtain an exemption for its funeral homes by adopting laws that provide protection substantially similar to the federal rule.

Harry and Bryant Co., 726 F.2d at 999. *Cf. Peerless Products, Inc.* v. *FTC*, 284 F.2d 825, 827 (7th Cir. 1960) (FTC "can restrain unfair business practices in interstate commerce even if the activities or industries have been the subject to legislation by a state or even if the intrastate conduct is authorized by state law."), *cert. denied*, 365 U.S. 844 (1961)).

The Commission in this proceeding considered and modified the Rule to be as consistent with state laws as possible,[42] explicitly expressed its intent not to occupy the field, and included a provision which allows states providing equal or greater protections to obtain an exemp-

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[42] For example, the prohibition on the taking of wages assignments was modified to exclude wages already earned at the time of the assignment to eliminate a potential problem in California where certain creditors must take assignments of earned wages to qualify as personal property brokers under state law or to qualify for higher interest rates. *See* 49 Fed. Reg. at 7760; *see also id.* at 7756-57, 7761-62.

tion. Under these circumstances, we cannot agree with petitioners that the Commission has exceeded its authority.

V. Conclusion

After carefully considering each of petitioners' challenges, we conclude that the FTC has not exceeded its authority to promulgate rules proscribing unfair practices under sections 5(a) and 18(a) of the FTC Act. We further find upon a thorough consideration of the record that the Commission's decision to proscribe the taking of HHG security interests and wage assignments is supported by substantial evidence and not arbitrary, capricious or an abuse of discretion. All other arguments advanced by the petitioners, intervenors, and amici were given due consideration and found to be unpersuasive. Accordingly, AFSA's and SCDCA's petitions for review are

Denied.

TAMM, *Circuit Judge, dissenting*: The Commission's decision to ban security interests in household goods and future earnings is in excess of its statutory authority to regulate unfair trade practices. Although rationalized in terms of "market imperfection" and "consumer choice," the Commission's action reflects nothing more than its paternalistic judgment that lenders should not extend credit to low-income consumers. Such a judgment not only violates the approach to consumer protection outlined in the Policy Statement but also will have the practical effect of forcing needy consumers out of the credit market. I therefore dissent.

I. INTRODUCTION

Two venerable principles of administrative law control the determination of whether the Commission has exceeded its authority in this case. First, the words "unfair trade practice" set forth a legal standard and must, therefore, gain their final meaning from judicial construction. *FTC v. R. F. Keppel & Bro., Inc.*, 291 U.S. 304, 314 (1934). *See also Office of Communication of the United Church of Christ v. FCC*, 707 F.2d 1413, 1423 (D.C. Cir. 1983) ("it is the quintessential function of the reviewing court to interpret legislative delegations of power and to strike down those agency actions that traverse the limits of statutory authority"). Informed judicial construction of the statutory language depends, however, upon "enlightenment gained from administrative experience." *FTC v. Colgate Palmolive Co.*, 380 U.S. 374, 385 (1965). Courts therefore traditionally accord respect to an interpretation of a statute by the agency charged with its execution. *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969) (such a construction "should be followed unless there are compelling indications that it is wrong, especially when Congress has refused to alter the administrative construction"). Thus, while we "give great weight to the Commission's conclusion," *FTC v. Cement Institute*, 333 U.S. 683, 720

(1948), "the final word is left to the courts." *Atlantic Refining Co. v. FTC*, 381 U.S. 357, 368 (1965). *Cf. FTC v. Colgate Palmolive Co.*, 380 U.S. at 385 ("[W]hile informed judicial determination is dependent upon enlightenment gained from administrative experience, in the last analysis the words 'deceptive practices' set forth a legal standard and they must get their final meaning from judicial construction.").

Second, for a reviewing court to determine whether the Commission's exercise of authority has "warrant in the record" and "a reasonable basis in law," *Atlantic Refining Co. v. FTC*, 381 U.S. at 368, 369, the Commission must, of course, articulate the reasons for the choices made. These reasons can be supplied by neither appellate counsel nor the court itself. The Commission's decisionmaking must be tested by the basis upon which it purports to rest; if the decisions made do not reasonably conform to the policies expressed, the court may not affirm. *See SEC v. Chenery Corp.*, 318 U.S. 80, 95 (1943) ("[A]n administrative order cannot be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained.").

II. The Definition of "Unfair" in the Policy Statement

Application of these basic principles to this case begins with the Commission's 1980 Policy Statement. Issued in response to congressional concern over the extent of the Commission's authority to regulate commerce, the Statement provides an authoritative interpretation of what trade practices can properly be regulated as unfair. The Statement outlines a market-oriented, nonpaternalistic test, conditioning Commission intervention in the marketplace upon a finding of a market failure that prevents consumers' purchasing decisions from regulating the market. Once a market failure is identified,

the Commission may proscribe practices resulting therefrom that are "injurious in their net effects."

Contrary to the majority's suggestion,[1] the Statement can guide the court in resolving the issues raised by petitioners in this case. Although it does not identify what specific conduct constitutes unfair trade practices, the Statement does establish limits to the "Commission's discretion under its unfairness jurisdiction." Federal Trade Commission, *Companion Statement to the Commission's Consumer Unfairness Jurisdiction* 6. As the majority recognizes, the principle limitation placed upon Commission authority is that it cannot, consistent with the Policy Statement, intervene merely because "it believes the market is not producing the 'best deal' for consumers." Majority opinion (Maj. op.) at 46. Determining what "deal" is best for consumers presumes that consumers are unable, without the benevolent guidance of the federal bureaucracy, to make purchasing decisions for themselves. Such a paternalistic approach to consumer protection is "fundamentally incompatible with the liberal assumption that each person is the best judge of his or her own needs." R. Reich, *Toward a New Consumer Protection*, 128 U. Pa. L. Rev. 1, 14 (1979). The Commission instead must "rely on consumer choice—the ability of individual consumers to make their own private purchasing decisions without regulatory intervention—to govern the market." *Policy Statement* at 7. At the same time, "certain types of seller conduct or market imperfections may unjustifiably hinder consumers' free

[1] The majority displays a remarkable ambivalence toward the Policy Statement. The Statement, the majority promises at one point, provides "tangible guideposts for review." Majority opinion (Maj. op.) at 18. It chooses, however, to ignore these guideposts, finding instead that the Policy Statement "falls short of providing any concrete guidance to the court in resolving the issues raised by petitioners in this case," *id.* at 25, and offers no more than "an abstract definition of unfairness." *Id.* at 24.

market decisions and prevent the forces of supply and demand from maximizing benefits and minimizing costs." Maj. op. at 33. In such instances of market failure, the Commission may take corrective action "to halt some form of seller behavior that . . . takes advantage of an obstacle to the free exercise of consumer decisionmaking." *Policy Statement* at 7.

Because no market responds perfectly to consumer choice, any market could conceivably be subject to wholesale Commission regulation. The reviewing court's first task, therefore, is to ensure that the Commission's intervention is a genuine response to a market failure "which prevents free consumer choice from effectuating a self-correcting market," Maj. op. at 44, and not a disguised attempt to impose a paternalistic purchasing decision upon consumers. To perform this task adequately, the court must insist that the Commission sufficiently understand and explain the dynamics of the marketplace. Furthermore, unless the Commission manifests an understanding of how the market responds to consumer choice, it cannot measure the costs and benefits of Commission intervention.

If the Commission has identified with sufficient clarity the impediment that blocks the market's natural allocation, it *may* be appropriate for the Commission to intervene. Whether intervention is appropriate, and if so, what form it should take, can only be answered by weighing the costs and benefits of the Commission's action.[2]

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[2] In reality, two closely related balancing tests must be made. First, the Commission must determine whether the specific trade practice involved actually harms consumers, that is, whether it is "injurious in its net effects." If the benefits of the trade practice to the consumer do not outweigh its costs, the trade practice is unfair. Even the prevention of an unfair practice, however, may not justify federal intervention. Thus, a second, more general, cost-benefit analysis must be made: whether the unfair trade practice can be profitably

III. Application of the Unfairness Test

A. *Market Failure or "Reasonably Avoidable Injury"*

The Commission discusses market failure in terms of what the consumer can "reasonably avoid"; if the consumer can "reasonably avoid" the practice, there is no market imperfection and, hence, no justification for intervention. The most common example of an injury consumers cannot "reasonably avoid" occurs when a seller has failed to disclose a risk involved in the exchange. Although the Commission states that the consumer's ability to shop and bargain for credit remedies is constricted by fine print and technical language, it found not only that consumers generally understand the consequences of default,[3] but that more information would not lead to different consumer decisions. 49 Fed. Reg. at 7746-47. Moreover, while it is true that creditors present standard form credit contracts on a take-it-or-leave-it basis, everyone in this proceeding recognizes that such contracts are the only efficient method of conducting loan transactions. *Id.*; Presiding Officer's Report at 76,

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regulated by the federal government. As the Commission states in its Policy Statement, this includes an assessment of the "burdens on society in general in the form of increased paperwork, increased regulatory burdens on the flow of information, reduced incentives to innovation and capital formation, and similar matters." *Policy Statement* at 7. Furthermore, as we stated in American Optometric Ass'n v. FTC, 626 F.2d 896, 910 (D.C. Cir. 1980), "principles of federalism" dictate deference by the Commission to "states' exercise of their police powers." In measuring the general regulatory burden, therefore, the disruptive effect federal regulation would have upon state regulatory schemes must be considered.

[3] In almost ninety percent of the loan contracts, the household goods taken as collateral are listed on the loan contract. Presiding Officer's Report at 157, J.A. at 489. In such instances, the Commission notes, there is "little question either that a security interest has been given or as to the scope of the coverage." 49 Fed. Reg. at 7762.

J.A. at 410 ("It is, beyond doubt, absolutely necessary to use form contracts in the interests of both creditors and consumers. Without such aids the consumer credit marketplace could not function in a reasonably efficient manner."). Creditors, therefore, do not unfairly take advantage of a market imperfection by imposing upon consumers hidden risks. Discussion by the Commission and the majority about standard form contracts and fine print is thus empty rhetoric, completely irrelevant to the market analysis.

Lacking any evidence of inadequate or undisclosed information that would distort consumer choice, the Commisison alternatively concludes that consumer choice is restricted because consumers do not have access to standard form contracts that do not contain the provisions in question. This conclusion rests on one of two premises—one factually incorrect, the other theoretically bankrupt.

First, the Commission could mean that consumers generally do not have access to loan contracts without these provisions. This is wrong as a matter of fact. Millions of consumers acquire credit each year without pledging any collateral. Millions more, forced to do business with pawnbrokers or loan sharks, do not even have access to loan contracts *with* these provisions. It is not simply common sense and everyday experience, however, that refutes the Commission's finding. The Presiding Officer found that "[i]t was generally agreed that consumers shopping among different classes of creditors *would find differences in terms* offered by banks as opposed to finance companies." J.A. at 404 (emphasis added).

Second, the Commission could mean that *high-risk* consumers do not have access to loan contracts that do not contain these provisions. Some consumers, to be sure, cannot avoid these provisions in loan contracts, so the provisions may constitute, *for those* consumers, an "obstacle to the free exercise of consumer decisionmaking." *Policy Statement* at 7. This phenomenon reflects a mar-

ket failure, however, only if one is willing to accept the proposition that the high-risk consumer should be free to choose the same credit as the credit-worthy consumer. Under the Commission's reasoning, since not every driver can choose the lowest insurance premium, by selling more expensive automobile insurance to the high-risk driver, the insurer takes advantage of an "obstacle to free choice." The only obstacle to free choice identified by the Commission is the level of risk the borrower, like the insured, brings to the transaction.

The Commission's analysis of the credit marketplace mocks the approach to consumer protection outlined in the Policy Statement. In the Policy Statement, the Commission asserts that the *status quo* is presumed to be the product of a well-functioning market. In the Credit Practices Rule, the Commission turns this presumption on its head: it proceeds from an *a priori* vision of the mix of options that would be available in a "well-functioning market," and, with little difficulty, concludes that the existing market, which does not provide that mix, is "imperfect." As the majority recognizes, the Statement prevents the Commission from intervening whenever "it believes the market is not producing the 'best deal' for consumers." Maj. op. at 46. Yet this is precisely what the Commission has done in this case. It simply identifies a particular class of consumers (those who cannot avoid loan contracts without security interests in household goods and future earnings) and concludes that those consumers ought to have access to credit without pledging household goods—that is, those consumers ought to have credit at a *better price*.

This is not to suggest that the credit marketplace responds perfectly to consumer choice. To justify its intervention, however, the Commission must at least rationally explain *how* the market fails to respond to consumer choice. Allowing the Commission to intervene when it does not know the "obstacle to free choice"

essentially reverses the presumption that each person is the best judge of his or her own needs. Such a paternalistic approach to consumer protection is fundamentally incompatible with the limits imposed upon the Commission's authority in the Policy Statement.

B. *The Cost-Benefit Analysis*

The Policy Statement's definition of "unfairness" provides that for an unavoidable consumer injury to be unfair, "the injury must not be outweighed by any offsetting consumer or competitive benefits that the sales practice also produces." *Policy Statement* at 6. Business practices entail a mixture of costs and benefits for consumers. Purchase money security agreements in automobiles, for example, can be a great cost to consumers because, upon default, consumers must forfeit the automobile, in many circumstances a vital necessity, or face costly refinancing agreements. The security agreements cannot be deemed unfair, however, because the benefits of the trade practice—making credit available to those who wish to purchase automobiles—clearly outweigh the costs.

The Commission makes two fatal errors in its cost-benefit analysis of security interests in household goods.[4] First, in measuring the costs of these security interests, the Commission fails to separate the injury *caused by* these creditor practices from the financial and emotional hardships that inevitably accompany default. Second, in evaluating the offsetting benefits of these provisions, the Commission never squarely addresses the single critical question: the extent to which the intended beneficiaries

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[4] Much of the criticism leveled at the cost-benefit analysis of household goods security interests also applies to the Commission's cost-benefit analysis of security interests in future earnings. I do not specifically address the latter, however, because the practice is already thoroughly regulated in the states where it is commonplace. *See* 49 Fed. Reg. at 7756.

of the Rule depend upon the ability to pledge household goods and future earnings to acquire credit.

1. Injury Caused by the Credit Practices

The Commission identifies several harms supposedly "caused by" security interests in household goods. First, household goods are necessities and forfeit of these necessities causes harm to the consumer and his family. This consequence of default, however, is not unique to security interests in household goods. Household goods—indeed houses themselves—can and will still be seized under other permissible credit remedies, such as a home mortgage or a purchase money security interest. Moreover, the Commission found that relinquishing household possessions to a pawnbroker in exchange for credit is not, in fact, "consumer injury." [5] Thus, a lender may hold a borrower's television set from the time a loan is made and keep it if the borrower defaults. According to the Commission, this is not a consumer injury. If the lender allows the borrower to use the television from the time the loan is made and, in extremely rare circumstances,[6] picks it up when the borrower defaults, he engages in an "unfair" trade practice.

Second, the Commission states that the threat of losing household goods increases the likelihood that debtors will forego valid defenses. The credit practices still available to creditors, particularly purchase money security interests, however, pose a far greater risk that debtors will forego valid legal defenses. The creditor who sells defective household goods, for example, is subject to a much

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[5] 49 Fed. Reg. at 7767 ("[t]he record furnishes no evidence" that giving a pawnbroker a possessory security interest "cause[s] any injury").

[6] As the Commission recognizes, defaults occur in only a fraction of transactions, and actual seizure occurs in but a "tiny fraction" of defaults. Brief for Respondent at 21; 49 Fed. Reg. at 7763.

greater array of defenses than is the creditor who simply loans money.

Third, the Commission states that the threat of repossession may cause the consumer to default improvidently on other loans to avoid repossession of his household goods. Defaulting on another loan, however, could only be "improvident" if the creditor remedies of that other loan were *more* onerous than the remedies threatened by the creditor. If this other loan has more onerous creditor remedies, it is difficult to see the marginal cost of these less onerous creditor provisions. If, on the other hand, the creditor remedies under this other loan are less onerous (a much more likely situation), it is not unwise to default. Moreover, the recognition that the threat of repossession may cause the debtor to choose to default on another loan is fundamentally inconsistent with the Commission's entire notion of the causes of consumer default. In determining whether the trade practice is unavoidable, the Commission states that default is beyond the debtor's control. On the other hand, in assessing the marginal cost of the trade practice, the Commission assumes that consumers faced with repossession will deliberately default on a loan not so secured to minimize their losses. The Commission cannot have it both ways.

Finally, the Commission states that the "unique" threat of repossession of household goods causes consumers to enter into costly refinance arrangements. The Commission contends that these horrible agreements "may reduce or defer monthly payments on a short-term basis . . . at the cost of increasing the consumer's total long-term debt obligation." Maj. op. at 29. *See* 49 Fed. Reg. at 7764-65. A creditor, therefore, unfairly takes advantage of a market imperfection by refusing to discharge debtors' contractual obligations unilaterally or by refusing to lend more money free of charge. Until the Commission can wish into being a world in which debtors

do not owe money and the use of money is free, the courts should require, I think, a less fatuous approach to consumer protection.

The economic hardships that inevitably accompany indebtedness and default will remain despite the prohibition of these creditor remedies. The Commission, therefore, grossly exaggerates the beneficial impact of the Rule. The Rule does not eliminate the need for credit, does not provide debtors with any more cash with which to discharge obligations, does not make default a less likely occurrence, does not relieve the financial and emotional hardships that accompany default, does not insulate household necessities from forfeit, does not protect consumers from unscrupulous lenders intent in any event upon breaking the law, and does not lessen the compounding burden unpaid debts place upon debtors.

2. Offsetting Benefits

Security interests in household goods benefit consumers to the extent that they enable consumers to acquire credit without resorting to the pawnbroker or the loan shark. The Commission, however, never squarely addresses whether any consumers' access to credit depends upon their ability to pledge household goods as collateral.[7]

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[7] The majority seems to place great weight on the econometric analysis conducted by various participants in the rulemakings, evidence which "by all accounts, contains deficiencies which prevent definitive answers." Maj. op. at 57. In spite of these deficiencies, however, the majority insists that the evidence reveals that the Credit Practices Rule "would have only a marginal impact on the cost or availability of credit." *Id.* at 33. What is "marginal" apparently is in the eyes of the beholder. The econometric studies revealed that the Credit Practices Rule would cost in 1979 between $623 million and $10.6 billion in increased interest rates. J.A. at 1528. I would agree, however, that the Rule has a *"marginal"* impact on credit availability: that is, those consumers currently at the *margin* will be forced out of the credit marketplace.

Instead, it evaluates the impact of the Rule—not upon the high-risk consumer it purports to protect—but upon the credit-worthy consumer who needs no protection from these "abusive" credit practices in the first instance.

The Presiding Officer considered this question and came to the following conclusion:

> However, this record does support the conclusion that the ability to take household goods as security is of very great importance to finance company creditors and that loss of this right would *undoubtedly have a very considerable impact on their operations and upon the availability of credit to consumers.*

Presiding Officer's Report at 162, J.A. at 494 (emphasis added). In a feeble attempt to weaken the force of the Presiding Officer's conclusions, the Commission states that the definition of "household goods," narrowed since the Officer's report, would address the problems of availability. Thus, the Commission notes, under the new definition of "household goods," consumers may still pledge works of art, antiques, jewelry, video tape recorders, home computers, and the like. Similarly, the Commission puts great stock in the finding that forty percent of finance company clients are homeowners and therefore have other assets to pledge. Furthermore, the Commission states, banks, which seldom take security interests in household goods or future earnings, remain available to the consumer.

What happened to the high-risk consumer the Commission so vividly describes when assessing the hardships caused by the creditor remedies? That consumer owned household goods of "little or no value." He had no cash with which to pay back the loan, no assets to liquidate to prevent the forfeiture of household necessities or the imposition of "costly refinancing arrangements." In assessing the impact of the Rule upon the availability of credit, the Commission converts the distraught debtor into a homeowner, able to acquire credit without pledging his

household goods because he can always visit his suburban bank or pledge his handy Matisse. The problem with the Commission's analysis is that the Rule unfortunately does not make the poor rich, or the high-risk consumer credit worthy. The Commission proves only that security interests in household goods cost the high-risk consumer more than they benefit the credit-worthy consumer.

Rather than address the Presiding Officer's conclusions, the Commission wishfully insists that creditors *should* extend credit to low-income, high-risk consumers without requiring from them security interests in household goods. 49 Fed. Reg. at 7766. Such security interests are of no real value to the creditor, the Commission reasons, because they do not deter default. Default cannot be deterred by security interests because it flows from circumstances beyond the debtor's control. This is nonsense on stilts. First, according to the record, twenty-five to thirty percent of defaulting debtors do so because of circumstances *within* their control. Five percent default because of "debtor irresponsibility"; twenty-five percent because of "voluntary overextension." *Id.* at 7748. The Commission never considers, however, whether eliminating these security interests would increase the number of debtors who default because of "voluntary overextension" or "debtor irresponsibility."

Second, even if every default occurred for reasons beyond the debtor's control, the Commission's conclusion that security interests do not deter default is a mammoth non sequitur. The Commission's reasoning is this: household goods security interests do not deter those who default; therefore, by eliminating the security interest the rate of default will not increase. By the Commission's logic, the existence of criminal laws does not deter those who violate the law. Can we therefore repeal the criminal laws and expect no impact upon crime? Of course not; just as we evaluate the impact of criminal laws upon those who do not violate the law, so must we

evaluate the impact of security interests upon those who do not default. As the Commission found, a majority of consumers face financial trauma that could result in a default. 49 Fed. Reg. at 7748. Yet only a small number of consumers actually default. *Id.* This disparity is explained to some extent by the varying degrees of financial trauma that individual consumers undergo. Unrebutted evidence in the record and a healthy dose of common sense also suggest, however, that the more equity a debtor has in collateral the less likely he is to default. *See* Bureau of Social Science Research, *Federal Trade Commission Proposals for Credit Contract Regulations and the Availability of Consumer Credit* 129, J.A. at 1518 (the ratio of the value of collateral to the size of the loan "is the principle determinant of the probability of default"). If, as common sense and record evidence suggest, security interests in household goods do deter default, lenders will rationally refuse to extend credit to at least some consumers who have no other assets to pledge. *See* Presiding Officer's Report 162, J.A. at 494 (elimination of household goods security interests "would undoubtedly have a very considerable impact . . . upon the availability of credit"). Derailed by its faulty logic, the Commission never makes the critical finding of how many low-income consumers, the intended beneficiaries of the Rule, will be unable, because of the Credit Practices Rule, to obtain credit.

IV. Conclusion

The flaws in the Commission's analysis form an intriguing pattern, a pattern resulting from the imperfect superimposition of the "market failure" and "consumer choice" rationale upon a simple, paternalistic judgment: those whose access to credit depends upon the pledge of meager household goods and future earnings would be better off if creditors were unable and unwilling to extend to them credit. If this is the rationale underlying the Rule, most, if not all, inconsistencies in logic and shortcomings in evidence disappear. The imperfections

of the marketplace need not be understood because it is not the obstacle to free choice that the Commission wishes to prevent but the free exercise thereof. Similarly, the harms caused by these practices need not be separated from the harms that inevitably accompany default because, if excluded from the credit marketplace altogether, these consumers will avoid not only these security interests but also all the other attendant hardships of default. Consumers who do not seek credit will, of course, avoid "costly refinance agreements" and never default "improvidently" on other loans. The Commission need not evaluate the impact of the Rule upon the intended beneficiary because the intended beneficiary, in its benevolent judgment, should not be seeking credit in the first instance.

The consumer law specialists involved in this case have at least been forthright in their support of the Credit Practices Rule. People who must pledge household goods or future earnings to acquire credit, they testified, would be better off without credit. Presiding Officer's Report at 162, J.A. at 484. Although held with genuine compassion, this belief cannot form the basis for the decision. First, it assumes that government intervention will eliminate the need for credit and that these people will not find credit elsewhere. Credit will be made available to them, however, by the pawnbroker or, worse, the loan shark, whose "creditor remedies" are infinitely more severe than those banned by the decision. Second, *"these people" are not children.* To suggest that "they" are incapable of making such decisions for themselves replaces healthy respect for the choice of the individual with unwarranted confidence in the wisdom of those who happen to be in power. Aware that such an approach to consumer protection is antagonistic to the basic principles outlined in the Policy Statement submitted to Congress, the Commission has couched its purely paternalistic judgment in terms of the market failure and cost-benefit analysis with enough skill to sneak past a court anesthetized by

a misplaced deference to agency authority. If judicial review is to have any meaning, however, agency action must be tested by the basis upon which it purports to rest and not by an agenda hidden from the court. *See SEC v. Chenery Corp.*, 318 U.S. 80, 95 (1943). Tested against the approach to consumer protection outlined in the Policy Statement, the Commission's decisionmaking must fail. I therefore respectfully dissent.

APPENDIX B

16 C.F.R. PART 444 CREDIT PRACTICES

§ 444.1 Definitions.

(a) *Lender.* A person who engages in the business of lending money to consumers within the jurisdiction of the Federal Trade Commission.

(b) *Retail installment seller.* A person who sells goods or services to consumers on a deferred payment basis or pursuant to a lease-purchase arrangement within the jurisdiction of the Federal Trade Commission.

(c) *Person.* An individual, corporation, or other business organization.

(d) *Consumer.* A natural person who seeks or acquires goods, services, or money for personal, family, or household use.

(e) *Obligation.* An agreement between a consumer and a lender or retail installment seller.

(f) *Creditor.* A lender or a retail installment seller.

(g) *Debt.* Money that is due or alleged to be due from one to another.

(h) *Earnings.* Compensation paid or payable to an individual or for his or her account for personal services rendered or to be rendered by him or her, whether denominated as wages, salary, commission, bonus, or otherwise, including periodic payments pursuant to a pension, retirement, or disability program.

(i) *Household goods.* Clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, and personal effects (including wedding rings) of the consumer and his or her dependents, provided that the following are not included within the scope of the term "household goods":

(1) Works of art;

(2) Electronic entertainment equipment (except one television and one radio);

(3) Items acquired as antiques; and

(4) Jewelry (except wedding rings).

(j) *Antique.* Any item over one hundred years of age, including such items that have been repaired or renovated without changing their original form or character.

(k) *Cosigner.* A natural person who renders himself or herself liable for the obligation of another person without compensation. The term shall include any person whose signature is requested as a condition to granting credit to another person, or as a condition for forbearance on collection of another person's obligation that is in default. The term shall not include a spouse whose signature is required on a credit obligation to perfect a security interest pursuant to state law. A person who does not receive goods, services, or money in return for a credit obligation does not receive compensation within the meaning of this definition. A person is a cosigner within the meaning of this definition whether or not he or she is designated as such on a credit obligation.

§ 444.2 Unfair credit practices.

(a) In connection with the extension of credit to consumers in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller directly or indirectly to take or receive from a consumer an obligation that:

(1) Constitutes or contains a cognovit or confession of judgment (for purposes other than executory process in the State of Louisiana), warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon.

(2) Constitutes or contains an executory waiver or a limitation of exemption from attachment, execution, or

other process on real or personal property held, owned by, or due to the consumer, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation.

(3) Constitutes or contains an assignment of wages or other earnings unless:

(i) The assignment by its terms is revocable at the will of the debtor, or

(ii) The assignment is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the consumer authorizes a series of wage deductions as a method of making each payment, or

(iii) The assignment applies only to wages or other earnings already earned at the time of the assignment.

(4) Constitutes or contains a nonpossessory security interest in household goods other than a purchase money security interest.

§ 444.3 Unfair or deceptive cosigner practices.

(a) In connection with the extension of credit to consumers in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is:

(1) A deceptive act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller, directly or indirectly, to misrepresent the nature or extent of cosigner liability to any person.

(2) An unfair act or practice within the meaning of Section 5 of that Act for a lender or retail installment seller, directly or indirectly, to obligate a cosigner unless the cosigner is informed prior to becoming obligated, which in the case of open end credit shall mean prior to the time that the agreement creating the cosigner's liability for future charges is executed, of the nature of his or her liability as cosigner.

(b) Any lender or retail installment seller who complies with the preventive requirements in paragraph (c) of this section does not violate paragraph (a) of this section.

(c) To prevent these unfair or deceptive acts or practices, a disclosure, consisting of a separate document that shall contain the following statement and no other, shall be given to the cosigner prior to becoming obligated, which in the case of open end credit shall mean prior to the time that the agreement creating the cosigner's liability for future charges is executed:

NOTICE TO COSIGNER

You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.

You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.

The Creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of *your* credit record.

This notice is not the contract that makes you liable for the debt.

§ 444.4 Late charges.

(a) In connection with collecting a debt arising out of an extension of credit to a consumer in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice wihin the meaning of Section 5 of that Act for a creditor, directly or indirectly, to levy or collect

any deliquency charge on a payment, which payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period, when the only delinquency is attributable to late fee(s) or delinquency charge(s) assessed on earlier installment(s).

(b) For purposes of this section, "collecting a debt" means any activity other than the use of judicial process that is intended to bring about or does bring about repayment of all or part of a consumer debt.

§ 444.5 State exemptions.

(a) If, upon application to the Federal Trade Commission by an appropriate state agency, the Federal Trade Commission determines that:

(1) There is a state requirement or prohibition in effect that applies to any transaction to which a provision of this rule applies; and

(2) The state requirement or prohibition affords a level of protection to consumers that is substantially equivalent to, or greater than, the protection afforded by this rule;

Then that provision of the rule will not be in effect in that state to the extent specified by the Federal Trade Commission in its determination, for as long as the state administers and enforces the state requirement or prohibition effectively.

APPENDIX C

APPENDIX C

FEDERAL TRADE COMMISSION

16 CFR Part 444

Trade Regulation Rule; Credit Practices

AGENCY: Federal Trade Commission.

ACTION: Final trade regulations rule.

SUMMARY: The Federal Trade Commission issues a final rule, the purpose of which is to restrict certain remedies used by lenders and retail installment sellers in consumer credit contracts. The remedies affected by this rule are: Confessions of judgment, waivers of exemption, wage assignments, security interests in household goods, and certain late charges. The rule further prohibits misrepresentations of cosigner liability and provides that potential cosigners be furnished a "Notice to Cosigner" which explains in general terms their obligations and liabilities.

This notice contains the rule's Statement of Basis and Purpose, incorporating a Regulatory Analysis, and the text of the final rule.

EFFECTIVE DATE: March 1, 1985.

ADDRESS: Requests for copies of the rule, the Statement of Basis and Purpose and Regulatory Analysis should be sent to Public Reference Branch, Room 130, Federal Trade Commission, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580.

FOR FURTHER INFORMATION CONTACT: Christopher W. Keller, Division of Credit Practices, Bureau of Consumer Protection, Federal Trade Commission, Washington, D.C. 20580 (202) 724-1580.

SUPPLEMENTARY INFORMATION:

List of Subjects in 16 CFR Part 444

Consumer credit contracts, Cosigner disclosures, Trade practices, Truth in lending.

By direction of the Commission. Commissioner Calvani did not participate.

Dated: February 17, 1984.

Benjamin I. Berman,
Acting Secretary.

CREDIT PRACTICES RULE; STATEMENT OF BASIS AND PURPOSE AND REGULATORY ANALYSIS

I. History of the Proceeding

A. Introduction

This proceeding focuses on the relationship between consumers and the institutions from whom they seek and obtain credit for purposes other than the purchase of real estate. It originated as a result of: (1) An extensive survey conducted by the National Commission on Consumer Finance which examined the consumer credit market and reached a variety of conclusions based upon empirical data and econometric analysis;[1] and (2) an investigation of the consumer finance industry conducted by the Bureau of Consumer Protection from the Fall of 1972 until the Spring of 1974, to determine whether the use of certain collection remedies was an unfair practice under Section 5 of the FTC Act.[2]

The Commission published an Initial Notice of Rulemaking in the Federal Register on April 11, 1975.[3] Written comments were received through August 5, 1977. Comments were received from industry, consumers, legal services, state attorneys general, labor unions, consumer organizations and other interested parties. A Final Notice of Rulemaking was published on June 24, 1977, setting forth the time and places for public hearings on the proposed rule and enumerating 14 issues which the Presiding Officer designated under § 1.13(d)(1) of the Commission's Rules of Practice.[4] Hearings

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[1] "Consumer Credit in the United States," *Report of the National Commission on Consumer Finance* (1972).

[2] Memorandum to Commission dated April 19, 1974.

[3] 40 FR 10347. This Notice contained a Statement of Reason for the Proposed Rule which set forth the legal theory applied to the acts and practices at issue in the proceeding, as well as a list of 12 questions which the Commission deemed particularly pertinent and upon which comment was specifically invited.

[4] 42 FR 32281, June 24, 1977.

were conducted in Dallas, Texas; Chicago, Illinois; San Francisco, California; and Washington, D.C., from September 12, 1977, to January 30, 1978. Rebuttal submissions were received until May 1, 1978.

The written comments, the materials placed on the record by the Presiding Officer and the Commission staff, the hearing transcripts and exhibits, and the rebuttal statements comprise the principal evidentiary record of this proceeding. After the receipt of rebuttal statements, reports to the Commission based on the rulemaking record were prepared by the Presiding Officer,[5] who made findings on designated issues, and by the Commission staff,[6] who summarized and analyzed the record evidence and made recommendations to the Commission for a revised Trade Regulation Rule. The Bureau of Economics also submitted comments and recommendations to the Commission for a revised rule.[7]

Pursuant to § 1.13(h) of the Commission's Rules of Practice, publication of the Final Staff Report initiated a sixty-day comment period which afforded the public an opportunity to comment on the reports of the Presiding Officer and the staff. This comment period was extended and closed on January 16, 1981. A summary of post-record comments was placed on the public record.

On April 14, 1983, the rulemaking staff's memorandum recommending a final modified proposed rule, and memoranda from the staff of the Bureau of Economics, and the Directors of the Bureaus of Consumer Protection and Economics were placed on the public record. On June 6 and 7, 1983, the Commission heard oral presentations from prior

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[5] Report of the Presiding Officer on Proposed Trade Regulation Rule: Credit Practices, August 11, 1978 (hereinafter cited as "Presiding Officer's Report").

[6] Credit Practices Staff Report and Recommendation on Proposed Trade Regulation Rule 16 CFR Part 444, August 1980 (hereinafter cited as "Staff Report").

[7] Memorandum by Edward Manfield, Bureau of Economics, August 18, 1980.

rulemaking participants who had been invited to present their views directly to the Commission as provided in § 1.13(i) of the Commission's Rules, 16 CFR 1.13(i).[8]

On June 13, 1983, the Commission met to consider whether to adopt a final rule, and if so, what form the rule should take. Although as to the rule as a whole no final determination was made during that meeting, the Commission deleted the provisions of the staff proposed rule concerning attorneys' fees and deficiency balances and directed the staff to draft proposed disclosures for the remaining provisions of the rule. The Commission further directed the staff to draft alternative proposals for a limitation on household goods security interests and third party contacts. The staff was instructed to draft a modified disclosure for cosigners. The Commission indicated tentative support for a ban on confessions of judgment and wage assignments. The Commission further indicated support for the late [7741] charges provision subject to clarification of the language to focus more clearly on the "pyramiding" problem.

On July 20, 1983, the Commission tentatively adopted the portions of staff's revised proposed rule banning confessions of judgment, waivers of statutory property exemptions, wage assignments, pyramiding late charges and blanket security

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[8] The participants were Commonwealth of Massachusetts, Department of the Attorney General; Credit Union National Association, Inc.; the Legal Aid Society of Cleveland; Professors James Barth and Anthony Yezer, George Washington University; National Automobile Dealers Association; American Financial Services Association. (Throughout the major portic of the proceeding this organization was denominated National Consumer Finance Association (NCFA) and will be so termed in relevant citations in this statement); Consumer Federation of America; George Wallace, Rutgers School of Law; Federal Reserve Board; American Retail Federation and National Retail Merchants Association; New Orleans Legal Assistance Corp.; Consumer Bankers Assoc., American Bankers Association, California Bankers Association, and Independent Bankers Association of America; National Consumer Law Center; and Legal Assistance Foundation of Chicago.

interests in household goods. The Commission also tentatively adopted staff's revised proposal requiring that potential cosigners be furnished with a "Notice to Cosigner" which explains their obligations and liability. The Commission rejected the provisions of the proposed rule pertaining to third party contacts and cross collateralization. The Commission determined that the effective date of the rule is to be one year from the date of promulgation.

B. Nature of Evidence on the Record

Publication of the proposed Credit Practices Trade Regulation Rule was preceded by a two-year investigation which culminated in subpoena returns from 12 large national consumer finance companies.[9] The subpoenaed material consists of over 7,000 individual files on delinquent debtors[10] and official company operating manuals and training materials.

In response to the invitation to comment on the proposed rule[11] the Commission received over 1,300 written comments. The comments are divided as follows by source: Banks (475); bank trade associations (19); finance companies (169); finance company trade associations (46); retailers (103); retail trade associations (8); credit unions (96); credit union trade associations (9); savings and loan associations (11); savings

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[9] These firms and debtor file record abbreviations are: Associates Financial Services (ASSOC), AVCO Financial Services (AVCO), Beneficial Finance Corporation (BEN), CIT Financial Services (CIT), Credit Thrift of America (CTA), Dial Financial Corporation (DIAL), General Electric Credit Corp. (GECC), General Finance Corp. (GFC), General Motors Acceptance Corp. (GMAC), Household Finance Corporation (HFC), Liberty Loan Corporation (LIB) and Transamerica Financial Corporation (TA).

[10] Several tabulations of information from the files were prepared by FTC staff and placed on the record. Because the staff collected files to illustrate potential problems with creditors' remedies, however, for most statistical purposes other surveys on the record are superior. The primary value of the files lies in the narrative information they contain.

[11] See *supra* note 3.

and loan trade associations (6); legal aid attorneys (117); consumer groups (23); governmental entities (36); other organized groups (18); and miscellaneous, including individual consumers (207). An additional 358 post-record comments were received during the 1980-81 reopening for comments on the Presiding Officer and Staff Reports.

Three hundred and nineteen witnesses appeared in ten weeks of hearings held in Chicago, Dallas, San Francisco and Washington from September 1977 through January 1978. The interests they represented were: Finance companies and their trade associations (95); banks and bank associations (25); retailers and their associations (12); credit unions and their associations (8); legal services attorneys (67); governmental entities (49); consumers and consumer groups (14); and miscellaneous (15). In all, 508 hearing exhibits were placed on the record.

C. Consumer Credit Market

Approximately 70 percent of household indebtedness is in the form of home mortgages; about 23 percent is in the form of installment consumer credit.[12] About 5 percent of consumer debt is noninstallment consumer credit, that is, 30 day charge credit held by retailers, travel and entertainment companies and single-payment loans at commercial banks for consumer purposes.[13] At the end of December 1981 total consumer noninstallment credit amounted to $78.4 billion.[14]

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[12] "Consumer credit" is defined by the Federal Reserve as "most short and intermediate-term credit extended to individuals through regular business channels, usually to finance the purchase of consumer goods and services or to refinance debts incurred for such purposes, and scheduled to be repaid (or with the option of repaying) in two or more installments." Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release, G. 19 (Feb. 10, 1978).

[13] NCFA 1982 Finance Facts Yearbook at 41.

[14] *Id.*

At the end of 1981, consumer installment credit totaled $333.4 billion.[15] Of that amount, 44.8 percent was held by commercial banks, 26.9 percent by finance companies, 13.8 percent by credit unions, 8.9 percent by retailers, 3.5 percent by savings and loan associations, 1.3 percent by gasoline companies, and 0.8 percent by mutual savings banks.[16]

By type of credit, $126.4 billion, or 37.9 percent of installment credit outstanding at end of 1981, was for the purchase of automobiles.[17] Revolving credit outstanding amounted to $63.0 billion at the end of 1981 (18.9 percent of the total). Commercial banks held $33.1 billion, retailers $25.5 billion and gasoline companies $4.4 billion.[18]

All other consumer installment financing of $125.4 billion comprised 37.6 percent of the total outstanding at the end of 1981. Commercial banks held $46.7 billion, finance companies $40.0 billion, and credit unions $23.5 billion. Retailers (including the wholly owned finance subsidiaries of chain stores) held $4.0 billion, savings and loan associations $8.4 billion, and mutual savings banks $2.8 billion. This "other" category includes installment contract financing of household goods such as appliances and furniture, as well as all personal loans.[19]

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[15] During the 1970's, the increases varied between $4.8 billion in 1970 and $43.1 billion in 1978. The increase in 1980 was only $1.5 billion.

[16] *Id.*

[17] Generally the automobile serves as security for installment contracts which are written by dealers and sold to banks or finance companies, or as security for auto loans made directly to consumers by banks and credit unions. Predominant in financing these purchases were commercial banks, with $59.2 billion outstanding of which $35.1 billion was purchased paper and $24.1 billion direct loans for the purchase of automobiles. Finance companies held $45.3 billion, most of which consisted of contracts purchased by the subsidiaries of manufacturers — that is, by General Motors Acceptance Corporation (GMAC), Ford Motor Credit and Chrysler Financial Corporation. Credit unions held $22.0 billion in loans made for the purchase of automobiles.

[18] *Id.*

[19] NCFA 1982 Finance Facts Yearbook at 42.

II. Legal Basis for the Rule

This proceeding focuses on certain of the terms and conditions that appear in the written contracts that consumers sign when they obtain credit for reasons other than the acquisition of real estate.[1] Its purpose is the evaluation of certain collection remedies and related practices in light of the requirements of Section 5 of the FTC Act. This Chapter of the Statement discusses the Commission's mandate to proscribe unfair or deceptive acts or practices and will serve to place in perspective subsequent discussions of the specific provisions of the rule.

The Commission's authority to promulgate this Trade Regulation Rule is derived from two sections of the FTC Act: Section 18(a)(1)(B) and Section 5(a)(1).[2]

A. Rulemaking Authority

Section 18(a)(1)(B) of the Federal Trade Commission Act states, in pertinent part, that the Commission may prescribe:

> [R]ules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce * * * [within the meaning of section 5(a)(1) of the FTC Act] * * * Rules under this subparagraph may include requirements [7742] prescribed for the purpose of preventing such acts or practices.[3]

The Commission believes that the record should contain a preponderance of substantial reliable evidence in support of a proposed rule before that rule is promulgated. This belief is based partly on the Commission's perception of its function and partly on statutory and judicial authority. Any rule promulgated by the FTC may be challenged in court and may be set aside if "the court finds that the Commission's action is

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[1] *See* Statement of Reason for the Proposed Rule at 40 FR 16346 (April 17, 1975).

[2] 15 U.S.C. 57(a)(1)(B); 15 U.S.C. 45(a)(1) (Cum. Supp. 1983).

[3] 15 U.S.C. 57(a)(1)(B) (Cum. Supp. 1983).

not supported by substantial evidence in the rulemaking record * * * taken as a whole," FTC Act section 18(e)(3)(A), 15 U.S.C. 57(e)(3)(A) (West Supp. 1983). Congress imposed this high standard as a " 'greater procedural safeguard []' " because of the 'potentially pervasive and deep effect' " of FTC rules. *American Optometric Ass'n* v. *FTC*, 626 F.2d 896, 905 (D.C. Cir. 1980) (quoting H.R. Rept. No. 1107, 93d Cong., 2d Sess. 45-46, 1974 United States Code Cong. and Ad. News 7702, 7715.) Therefore, the Commission takes seriously its responsibility to determine if there is a preponderance of substantial reliable evidence to support a proposed rule, and to see that any supporting evidence is clearly recorded.

Initially, the Commission requires substantial evidence for the factual propositions underlying a determination that an existing act or practice is legally unfair or deceptive. When substantial evidence both supports and contradicts such a finding, the Commission bases its decisions on the preponderance of the evidence. Before promulgating a rule, however, rather than bringing individual cases, the Commission believes the public interest requires answers to the following additional questions: (1) Is the act or practice prevalent? (2) Does a significant harm exist? (3) Will the proposed rule reduce that harm? and (4) Will the benefits of the rule exceed its costs?[4] In analyzing each of these questions, three types of evidence are frequently brought to bear: Quantitative studies, expert testimony, and anecdotes. The Commission has the flexibility to marshall evidence for a rulemaking record that combines the best mix of these three. However, it has a

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[4] Although the Commission believes that these questions should be asked and, to the extent possible, answered in every rulemaking, on the basis of the best evidence reasonably available, it recognizes there is room for variation in the specific answers that would justify the issuance of a rule, depending upon the circumstances of each particular rulemaking. Different industries lend themselves in varying degrees to answering these questions, the characteristics of the industry, the ability to reasonably gather information, the burdensomeness of the regulation, and the agency's ability to address the unfair or deceptive practive by alternative means must be considered.

responsibility to see that the best evidence reasonably available is included.[5]

The best evidence will often be surveys or other methodologically sound quantitative studies. Carefully prepared studies can often give a reliable answer to each of the four questions. First, reliable estimates of the incidence of a practice are an integral part of an assessment of prevalence and are frequently well-suited to quantitative methods. Second, the overall harm caused by a problem is best measured by determining both the magnitude of consumer injury when it occurs and the frequency of such an injury. This issue is also well-suited to quantitative analysis. Third, the effectiveness of a proposed remedy can often be shown only by quantitative studies since informally observed changes may be influenced by other, uncontrolled factors, or may be the result of chance (*i.e.*, not statistically significant). Finally, quantitative studies are most helpful when comparing costs with benefits.

In many instances, of course, precise quantitative answers to these questions are not possible, or could be obtained only at a prohibitive cost. In such cases, the Commission will seek alternative ways to conduct a systematic assessment of the benefits and costs of its regulatory proposals. As in considering the merits of a rule, the Commission will balance the benefits and costs of obtaining additional information. Although carefully structured quantitative studies are generally preferred as evidence in a rulemaking record, the Commission believes that it is possible in some instances to support a rule without such studies.

The second type of evidence is expert testimony. The primary use of expert testimony is in providing underlying technical details, such as medical or engineering facts or

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[5] The concept of "reasonably available" takes into account the practical resource constraints on the ability of the Commission or parties to a rulemaking to marshal evidence bearing on a particular problem.

information concerning state law and procedures. Expert testimony is also useful to address the methodology of quantitative studies, and its possible effects on the results. Finally, experts can give their own opinions regarding the issue facing the Commission. These opinions are usually predictions of what quantitative studies would show. As such, they are less satisfactory than an actual study. When an expert's opinion conflicts with the conclusions of a study, the study itself is generally more reliable, unless deficiencies in the methodology or execution of the study have been established and a better study would, in all likelihood, support the expert's opinion.

A third type of evidence is anecdotes. Narratives of specific consumer injuries are helpful in certain ways. They call attention to a possible problem; they illustrate the contours of a known problem; and they may suggest areas for further inquiry. By themselves, anecdotes are generally good evidence that some harm exists. Without thorough exploration of the details of individual examples, however, anecdotes cannot establish the cause of a problem. Moreover, anecdotes give little evidence of the frequency of the harm, they provide limited evidence for the effectiveness of a proposed rule and virtually no evidence of the balance of benefits and costs. Therefore, anecdotal evidence is rarely sufficient to provide the "substantial evidence" which the Commission requires in the rulemaking record.

B. The Criteria for Unfairness Under Section Five[6]

Section 5(a)(1) of the FTC Act, in turn, states:

> Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices

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[6] Although a majority of the adopted rule provisions are based on the Commission's authority to regulate unfair acts or practices, § 444.3(a)(1), which concerns misrepresentations of the nature or extent of cosigner liability, is premised on the FTC's jurisdiction over deceptive acts or practices. A discussion of the Commission's authority to identify and correct consumer deception is set forth in Chapter IX, *infra*.

of a consumer credit transaction.[18] Other states restrict their use in specified classes of transactions, such as retail installment sales contracts, but do not impose a general prohibition on [7750] their use with respect to all consumer transactions.[19] In addition, a significant number of states prohibit small loan

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[18] *See, e.g.*, Colo. Rev. Stat. sections 5-2-415, 5-3-407 (1973); D.C. Code Ann. section 28-3804 (1981); Idaho Code section 28-43-305 (Supp. 1983); Ill. Ann. Stat. ch. 110, section 2-1301 (Smith-Hurd 1983); Ind. Code Ann. sections 24-4.5-2-415, 24-4.5-3-407 (Burns 1982); Kan. Stat. Ann. section 16a-3-306 (1981); Me. Rev. Stat. Ann. tit. 9-A, section 3.306 (1980); Mass. Gen. Laws Ann. ch. 231, section 13A (West 1974); N.M. Stat. Ann. sections 39-1-16, 39-1-18 (1981); Ohio Rev. Code Ann. section 2323.13 (Page 1981); Okla. Stat. tit. 14A, sections 2-415, 3-407 (1983); S.C. Code Ann. sections 37-2-415, 37-3-407 (Law. Co-op. 1976); Utah Code Ann. sections 70B-2-415, 70B-3-407 (1980); Vt. Stat. Ann. tit. 9, section 2455 (1970); W. Va. Code section 46A-2-117 (1980); Wisc. Stat. Ann. section 806.25 (West 1977), section 422.405 (West 1974); Wyo. Stat. sections 40-14-249, 40-14-338 (1977).

[19] *See, e.g.*, Conn. Gen. Stat. Ann. section 42-86 (1958) (Confession of judgment void in retail installment contract or installment loan contract); Hawaii Rev. Stat. section 476-13 (1976) (void in retail installment contract); Md. Com. Law Code Ann. sections 12-601, 12-607 (1983) (prohibited in retail installment sales agreements between buyer and seller or sales finance company); Mich. Comp. Laws Ann. section 445.852 (1976), section 445.864 (Supp. 1983-84)(prohibited in retail installment contract or retail charge agreement for goods or services); Minn. Stat. Ann. section 325G.16 (West 1981)(prohibited in consumer credit sale for goods or services); N.H. Rev. Stat. section 361-A:7 (1968)(void in retail installment contract for purchase of motor vehicle); N.J. Rev. Stat. section 17:16C-37 (Supp. 1983-84)(void in retail installment contract or retail charge account); N.J. Rev. Stat. section 17:16C-64 (1975)(void in home repair contract); N.Y. Pers. Prop. section 403 (Consol. 1976)(prohibited in retail Installment contracts); N.Y. Civ. Prac. Law section 3201 (McKinney 1970)(void if executed before default in connection with the purchase of consumer goods for $1500 or less); N.C. Gen. Stat. sections 25A-2, 25A-18 (Supp. 1983)(void in connection with claim arising out of a consumer credit sale for goods or services); N.D. Cent. Code section 51-13-02.1 (1982)(prohibited in retail installment contracts); Or. Rev. Stat. section 83.670 (1973) (unenforceable in retail installment contract for motor vehicle); Tex. Rev. Civ. Stat. Ann. Art. 5069-6.05 (Vernon Supp. 1982-83)(prohibited in retail installment contract or retail charge agreement).

licensees from utilizing confessions of judgment in loan agreements with consumers.[20] The statutory definition of a small loan licensee varies from state to state, however.[21] Thus, the protection such provisions afford consumers varies accordingly.

Other states authorize confessions of judgment, but only if they are executed after action on the underlying obligation

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[20] *See, e.g.*, Ala. Code section 5-18-16 (1975); Ariz. Rev. Stat. Ann. section 6-629 (1974); Cal. Fin. Code section 22467 (Deering Supp. 1983); Conn. Gen. Stat. Ann. section 36-236 (West 1961); Fla. Stat. Ann. section 516.16 (West 1972); Hawaii Rev. Stat. section 409-15 (1978); Ky. Rev. Stat. Ann. section 288.580 (Bobbs-Merrill Supp. 1982); Md. Com. Law Code Ann. section 12-311 (1963); Mich. Comp. Laws Ann. section 493.12 (Supp. 1983-84); Minn. Stat. Ann. section 56.12 (West 1970); Miss. Code Ann. section 75-67-127 (Supp. 1983); Mont. Code Ann. section 32-5-305 (1981); Neb. Rev. Stat. section 8-447 (1977); Nev. Rev. Stat. section 675.350 (1979); N.H. Rev. Stat. Ann. section 399-A.5 (1968); N.J. Rev. Stat. section 17:10-15 (Supp. 1983-84); N.Y. Banking Law section 353 (Consul. 1970); N.C. Gen. Stat. section 53-181 (1982); N.D. Cent. Code section 13-03-15 (1961); R.I. Gen. Laws section 19-25-24 (1968); Tex. Rev. Civ. Stat. Ann. Art. 5089-3.20 (Vernon 1974); Vt. Stat. Ann. tit. 8, section 2222 (1970); Va. Code section 6.1-283 (1983); Wash. Rev. Code section 31.08.150 (Supp. 1983-84).

The Presiding Officer indicated that 29 states bar the use of confessions of judgment by small loan licensees. Presiding Officer's Report at 81. In the interim, six states—Idaho, Indiana, Oklahoma, South Carolina, Utah, and Wyoming—have replaced such statutes with statutes that prohibit confessions of judgment in all consumer loan transactions. Pennsylvania also repealed its statute invalidating confessions of judgment in small loan transactions. Pennsylvania's statutory limitations on confessions of judgment are discussed *infra* at note 33. California and Rhode Island were not included in the Presiding Officer's total. These states prohibit confessions of judgment in most small loan transactions, however.

[21] *Compare* Mont. Code Ann. section 32-5-103 (1961) (licensee is any person engaged in business of making loans or advances of money on credit in amounts of $25,000 or less) *with* Hawaii Rev. Stat. section 409-15 (1976)(licensee is any person engaged in business of making loans of money, credit, goods, or things in action in the amount or value of $300 or less).

The statutory definition of a licensee typically excludes federal and state banks, trust companies, savings or building and loan associations and credit unions. It often also excludes pawn-brokers and retail sellers. *See, e.g.*, Ariz. Rev. Stat. Ann. section 6-602 (Supp. 1983-84); Mont. Code Ann. section 32-5-103 (1981).

has been instituted.[22] The hallmark of the common law cognovit is the waiver of due process rights before the time that the debtor needs their protection. Because such statutes prohibit waiver of these rights before commencement of an action against the debtor, in effect they bar the common law cognovit and the ills traditionally associated with it.[23] Before an action can be commenced the debtor must receive notice, and the right to a hearing necessarily follows. If at this point the debtor chooses to confess judgment, the waiver of the right to a trial on the merits may be assumed to have been made intelligently and voluntarily. A few other states restrict confessions of judgment by requiring that they be entered into after default, rather than after institution of suit,[24] or by requiring that the debtor appear personally in court to confess judgment if he or she chooses.[25]

Another group of states restricts confessions of judgment by authorizing their use but requiring that the debtor sign a verified statement under oath attesting to the existence of the obligation due or to become due.[26] Such provisions may help

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[22] *See, e.g.*, Ala. Code section 8-9-11 (1975); Fla. Stat. Ann. section 53.05 (West 1969); Ga. Code Ann. section 110-801 (1973); Ky. Rev. Stat. Ann. section 372.140 (Bobbs-Merrill 1970); Miss. Code Ann. section 11-7-187 (1972); Or. R. Civ. P. 73 (1981); Tenn. Code Ann. section 25-2-101 (1980); Tex. Rev. Civ. Stat. Ann Art. 2224.

[23] As a result, confessions of judgment obtained pursuant to such statutes are not prohibited by this rule provision. *See infra* note 106 and accompanying text.

[24] *See, e.g.*, Ariz. Rev. Stat. Ann. section 44-143 (1962); Iowa Code Ann. section 537.3306 (West Supp. 1983-84).

[25] *See, e.g.*, Ark. Stat. Ann. section 29-301 (1979); Neb. Rev. Stat. section 25-1309 (1979).

[26] *See, e.g.*, Alaska Stat. section 9.30.050, Alaska R. Civ. P. 57 (c) (1973); Cal Civ. Proc. Code sections 1132-1134 (Deering 1981) (confession may be entered only if an attorney independently representing the debtor signs a certificate that the attorney has examined the proposed judgment, has advised the debtor with respect to waiver of rights and defenses, and has advised the debtor to utilize the procedure); Mo. Rev. Stat. sections 511.070-511.100 (1974); Mont. Code Ann. sections 27-9-101, 27-9-102 (1981); Nev. Rev. Stat. sections 17.090-17.110 (1979); S.D. Codified Laws

to focus the debtor's attention upon the existence of the cognovit clause at the time due process rights are waived. They do not ensure that the waiver is made intelligently, however, or at a time that the waiver has meaning for the debtor.[27]

A few states provide for the entry of a judgment by confession without requiring verification of the confession under oath and also without providing the debtor with notice and a hearing at the time of entry. Instead, these states rely on post-judgment procedures to alleviate wrongful deprivation that the debtor may have suffered.[28] The required procedures provide varying degrees of protection to the debtor. Delaware, for example, provides for a hearing on the question of whether the debtor understood the constitutional rights waived at the time the judgment was confessed.[29] Before judgment becomes final the court clerk must send notice to the debtor by certified mail of the opportunity for such a hearing. In addition, the debtor may seek to vacate or reopen the judgment and may present any defenses not deemed to have been waived, *i.e.*, any defenses of which the debtor had no knowledge at the time of the confession of judgment or that arose subsequently.[30]

Virginia law provides that any confessed judgment may be reduced or set aside within twenty-one days following notice to the debtor of its entry on any ground that would have constituted an adequate defense or set off to the underlying claim.[31] It also requires the court clerk to notify the debtor of

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Ann. sections 21-26-1--21-26-6 (1979); Wash. Rev. Code sections 4.60.060-4.60.070 (1974).

[27] The California statute is an exception in requiring detailed procedures designed to ensure intelligent waiver. *See supra* note 26.

[28] *See, e.g.*, Del. Code Ann. tit. 10, sections 2306, 3908 (1974); Pa. Ct. R. Civ. P. 2950-2962 (West 1983); Va. Code sections 8.01-431—8.01-441 (1977).

[29] Del. Code Ann. tit. 10, section 3908 (1974).

[30] *Id.*

[31] Va. Code section 8.01-433 (1977).

the right to contest judgment on these grounds.[32] Unlike Delaware, however, Virginia does not specifically provide for a hearing on the preliminary question of intelligent or understanding waiver.

Pennsylvania also authorizes the entry of judgment by confession against a debtor without advance notice and hearing. Although some statutory restrictions apply,[33] it appears that **[7751]** confessions of judgment are used relatively frequently in this state.[34] Pennsylvania's procedural protections are more limited than those of Delaware and Virginia. In Pennsylvania, judgment is entered by the filing of an instrument confessing judgment or authorizing a third party to confess judgment against the debtor. Default is not a necessary condition precedent to the entry of judgment.[35] The court clerk must notify the defendant debtor of the entry of judgment and enclose copies of the documents filed in support of judgment. Such notice is sent by ordinary mail rather than certified mail, however, and no return receipt is required.[36] Thus,

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[32] *Id.* at section 801-438.

[33] Pennsylvania law permits a creditor to take a confessed judgment from a debtor. It also permits the creditor to enter judgment against the debtor at any time before default and to use it to create a lien on the debtor's real and personal property. The debtor's residential real estate is protected from execution on the basis of such a lien, however, in that execution may not occur until after a trial on the merits of the claim. 41 Pa. Cons. Stat. Ann. section 407 (Purdon Supp. 1983-84).

Similarly, execution may not be had on such a basis as to any of the debtor's property without first proceeding as in any original action when the claim arises out of a retail installment sale, contract or account. 69 Pa. Cons. Stat. Ann. section 1605 (Purdon Supp. 1983-84). This chapter prohibits the use of a power of attorney to confess such a judgment, *see id.* at section 1401(e), but not the taking of confession from a debtor.

In contrast, home improvement contracts may contain a power of attorney clause authorizing confession of judgment. Judgment may be entered before default, thereby creating a lien, but execution before default is prohibited. Pa. Stat. Ann. tit. 73, section 500-406 (Purdon 1971).

[34] *See* discussion of prevalence *infra* Section C.

[35] Pa. Ct. R. Civ. P. 2951 (West 1983).

[36] Pa. Ct. R. Civ. P. 236 (West 1983).

the court has no assurance that the debtor has, in fact, received notice. Failure to mail the notice and documents does not affect the lien against the debtor's property imposed by the judgment.[37] As a result, debtors may be wholly unaware that their property is subject to a lien.

Pennsylvania law provides for striking off or reopening of a judgment entered by confession.[38] To strike a judgment the defendant's petition must assert defects appearing on the record. To reopen a judgment the defendant's petition first must assert prima facie grounds for relief. The existence of offsetting claims or counterclaims that the debtor has against the creditor does not constitute grounds for reopening.[39] All defenses that are not included in the petition are waived. The court determines whether to reopen the judgment on the basis of the defendant's petition, the plaintiff's answer, and on testimony, depositions, and admissions. There is no statutory provision for a hearing on the petition to reopen. Only if the pleadings produce evidence that would require submission of the issues to a jury will the court reopen the judgment.[40] Thus, the reopening of a judgment entered by confession involves a preliminary pleading contest in which the debtor has the burden of persuasion.[41]

In the event that the court does reopen the judgment, the lien of the judgment or of any execution issued on it is unimpaired, although the court may stay execution pending final

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[37] *Id.*

[38] Pa. Ct. R. Civ. P. 2959 (West 1983).

[39] *See supra* note 5.

[40] Pa. Ct. R. Civ. P. 2959 (West 1983). A "defendant must allege a meritorious defense to liability on the note, and must produce evidence sufficient to present a jury question and avoid a directed verdict." *Federal Deposit Insurance Corp. v. Barness* 484 F. Supp. 1134, 1141 (E.D. Pa. 1980).

[41] "The placing of this burden upon the debtor is in direct contrast to the burdens in a normal or pre-judgment creditor-debtor action. In those cases instituted by a creditor against a debtor, the creditor is considered the proponent of a claim and the burdens are his." *Swarb v. Lennox*, 314 F. Supp. 1091 (E.D. Pa. 1970), *aff'd*, 405 U.S. 191 (1972).

disposition of the proceeding.[42] This is a discretionary matter, however; the court is not required to stay execution. No further pleadings are permitted after reopening.

Although these statutory provisions afford some means of contesting a judgment that has been improperly entered, they fail to ensure that debtors' rights will be protected adequately. This is true because, as noted above, there is no assurance that debtors will receive notice of the entry of judgment. Even when debtors do receive notice of the entry of judgment, the law does not require that they be notified of the right to contest the judgment or the grounds upon which they may do so.[43] Evidence in the rulemaking record shows that debtors may fail to recognize the implication of judgments entered by confession against them, as well as the means that they may use to contest such judgments.[44] Moreover, ignorance of the rights that were waived at the time of confession is not a statutory defense in Pennsylvania.[45] Finally, debtors' due process rights are inadequately protected by Pennsylvania statute because the law permits encumbrance of their property before, rather than after, a hearing on the merits of the creditors' claims.

It is also apparent that Pennsylvania's post-judgment remedies do not provide the procedural equivalent of a trial de novo to debtors. A creditor in Pennsylvania who has not obtained judgment by confession must seek judgment

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[42] 7 Stand. Pa. Prac. 172, 174, sections 138, 142.

[43] This contrasts with Virginia law, for example, which requires such notification to the debtor. *See supra* note 32 and accompanying text.

[44] *See, e.g.*, Henry J. Sommer, Community Legal Services of Philadelphia, Tr. 10980; Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11104; Herschel T. Elkins, Office of the Attorney General of California, HX-211, Tr. 5290-91.

[45] Bernard A. Podcasy, Legal Services of Northeastern Pennsylvania, Tr. 9629. This contrasts with Delaware law, for example, which provides for a preliminary hearing on the issue of waiver. *See supra* note 29 and accompanying text.

through a civil suit.[46] The action is commenced when the creditor files a complaint. The district justice sets a date for hearing, to occur within sixty days of the filing, and notes it on the complaint. The complaint is then served personally upon the debtor, along with a notice of the right to contest and the time period for doing so. The notice includes a prominent warning that failure to appear will result in the entry of a default judgment. Debtors are informed that they may enter a defense and may also file a complaint raising a cross-claim against the creditor. Such a complaint may assert any claim within the court's jurisdiction. The district justice who conducts the hearing has authority to subpoena any necessary witnesses. The court issues a judgment within five days after the hearing. Costs are awarded to the prevailing party.[47]

This procedure is simple, straightforward, and expeditious. It ensures service of process upon the debtor. It provides full notice of the debtor's right to defend, the time and place for doing so, and the consequences of failure to appear. Because depositions and interrogatories are not permitted, the burden and expense of presenting a defense are negligible.

The reopening of a confessed judgment involves a preliminary pleading contest in which the debtor has the burden of persuasion. By contrast, to defend against a creditor's claim in a trial de novo under the procedures outlined above, the debtor may simply appear and present any defenses to the district justice. No lien may be created upon the debtor's property until after the debtor has had this opportunity.

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[46] The civil procedure discussed in this section is the applicable procedure in cases brought before Pennsylvania district courts, which have jurisdiction over claims not exceeding $4,000. *See* Pennsylvania Rules of Civil Procedure Governing Actions and Proceedings Before District Justices, Pa. Ct. R. Civ. P. 301-382, (West 1983). Claims that exceed $4,000 must be brought in the Court of Common Pleas.

[47] If judgment is entered against the debtor, execution may be ordered by the district justice; alternatively, the creditor may file the judgment with the Court of Common Pleas. Creditors wishing to execute upon real property must choose the latter alternative. *See id.*, Pa. Ct. R. Civ. P. 402, 406.

Notwithstanding a meritorious defense, the procedural burden of reopening a judgment under Pennsylvania law requires a greater sophistication and expenditure of [7752] resources by the debtor than would be required in a trial on the merits in the first instance. For these reasons, Pennsylvania's post-judgment remedies provide an inadequate substitute for a trial de novo and fail to guarantee that debtor's rights will be protected to the degree that due process requires.

C. Prevalence

There is limited record evidence with respect to the prevalence of cognovit clauses in consumer credit contracts on a nationwide basis. Both legal aid attorneys and members of the finance industry testified to the use of confessions of judgments in Pennsylvania,[48] Illinois,[49] and Louisiana.[50] Other evidence points to frequent use in Pennsylvania, Illinois, and Ohio.[51] There was also testimony that in Maryland, although confessions of judgment are prohibited in many

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[48] Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11121 (100 cases in 3 years); Bernard A. Podcasy, Legal Services of Northeastern Pennsylvania, Tr. 9635 (3 current cases, perhaps 50 others); William T. Gwennap, Pittsburgh National Bank, Tr. 12232-34 (PNB uses cognovits in home improvement loans; other banks in Pennsylvania also use them); Leslie R. Butler, Consumer Bankers Association, HX-488, Tr. 11587 (in Pennsylvania many consumer contracts contain cognovits).

[49] Jerrold Oppenheim, Legal Assistance Foundation of Chicago, HX-79, Tr. 2147. Confessions of judgment have since been prohibited in consumer transactions in Illinois.

[50] Jane Johnson, New Orleans Legal Assistance Corp., Tr. 407-08; Herschel C. Adcock, Louisiana Consumer Finance Association, Tr. 1210 *et seq.*; Donald S. Wingerter, Louisiana Savings and Loan League, HX-437, Tr. 10890 *et seq.*

[51] *See* Hopson, *Cognovit Judgments: An Ignored Problem of Due Process and Full Faith and Credit*, 29 U. Chi. L. Rev. 111, 115 (1961) (these states produce the "overwhelming bulk" of cognovit judgments). Ohio, like Illinois, now prohibits the use of a warrant of attorney to confess judgment in instruments arising out of a consumer loan or transaction.

consumer credit transactions, their use in other kinds of consumer contracts remains common.[52]

Survey evidence exists concerning the prevalence of cognovit clauses but does not break down the results by state. A survey of its members conducted by the Consumer Bankers Association, for example, shows that approximately 20 percent of banks responding to the survey included cognovit clauses in the majority of their contracts where permitted by law.[53] A survey of legal aid attorneys indicates that, where permitted by law, cognovit clauses were utilized in 20 percent of loan agreements by credit unions, 21 percent by finance companies, 16 percent by banks, and 30 percent by creditors generally.[54]

A National Consumer Finance Association (NCFA) survey of over 13,000 consumer accounts indicates that cognovit clauses were used in 3.7 percent of consumer credit contracts used by its responding members and that all but one of the

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[52] H. Robert Erwin, Consmer Law Center, Legal Aid Bureau, Baltimore, Tr. 10034 (*e.g.*, home improvement contracts).

[53] Richard K. Slater, Consumer Bankers Association, HX-490, Tr. 11630. Mr. Slater indicated that the banks responding to the survey held over 15 percent of all consumer credit outstanding in the types of credit extension that the survey addressed and a much larger market share overall. Thus, he believed that the survey responses were respresentative of the overall marketplace, Tr. 11616-17. Although Mr. Slater was unable to present the results on a state-by-state basis, he indicated that the number of respondents was too great to reflect banking practice only in Pennsylvania. Tr. 11637. He noted that a number of the respondents did business in Michigan, Illinois, and New York. Tr. 16642.

[54] National Consumer Law Center (NCLC) Survey of Credit Contract Practices (1977), HX-467 at 44. Although 105 consumer law specialists responded to this survey, confessions of judgment were not lawful in many of the respondents' states. The estimate of prevalence reflects the opinions of the 22 respondents in whose states the practice was permitted, but results were not tabulated by state. Thus, the 20 percent estimate of prevalence may reflect the practice of creditors in a relatively small number of states. *See* Presiding Officer's Report at 302-04 for an evaluation of this survey as a whole.

contracts came from Illinois or Louisiana.[55] A Commission staff survey of 1,001 consumer account files subpoenaed from twelve large consumer finance companies in thirty-five states found cognovit provisions in seventy-four contracts (7.3 percent).[56] This figure was thought to underestimate the true incidence of cognovit provisions in the sample, however.[57] A more reliable Bureau of Social Science Research (BSSR) survey of 1,001 consumer account files drawn from the same group, but including only nine consumer finance companies in nineteen states, found cognovit provisions in ninety-six contracts or 9.5 percent of the sample.[58] The results of both samples show that cognovits appeared in contracts from Colorado, Illinois, Indiana, Louisiana, New Jersey, Michigan, Ohio, Tennessee, and Virginia.[59] Although Louisiana, Illinois, and Ohio account for the majority of the cognovit provisions in the sample,[60] consumer account files from these states are over-represented in the sample. Eleven percent of the consumer account files were from Ohio, for example.[61] Because the consumer files upon which these surveys were based were not drawn from all states and because some states were disproportionately represented in the file samples, the results do not necessarily reflect those states in which cognovits were used most frequently nor the frequency of their use in a given

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[55] Robert P. Shay, National Consumer Finance Association, HX-494 at 33, Tr. 12053.

[56] For an explanation of the methodology employed and the results of this and the BSSR survey *see* R-XI-153 at 3-5, 9-10. For criticism of the underlying sampling methodology, *see* Robert P. Shay, National Consumer Finance Association, HX-494 at 4-10.

[57] *See* R-XI-153 at 4-5. Because many of the files surveyed by the Commission staff were incomplete, it was not possible to determine in all cases whether a given contract provision was included. In addition, if a provision was found in all contracts from a given office, staff did not attempt to code each incidence of the provision. The BSSR survey, in contrast, used complete files and followed formal coding procedures.

[58] *Id.* at 9.

[59] *Id.*, printout A at 14-21, printout B at 1-6.

[60] *See id.*

[61] *Id.* at 3, n.4.

state. They do suggest, however, that the use of cognovits may be somewhat more widespread geographically than the NCFA survey would indicate.[62]

Finally, a 1970 industry survey conducted by the National Commission on Consumer Finance showed that 17 percent of large bank respondents and 17 percent of large finance companies stated cognovits to be a highly valuable provision in contracts for unsecured cash loans. This suggests that, among these respondents, confessions of judgment are employed on a regular basis.[63]

No precise quantification of the extent to which cognovits are used in consumer credit contracts can be made on the basis of record evidence. Evidence demonstrates their use in Pennsylvania, as well as in Louisiana, Ohio, Illinois and, at least to a limited extent, in several other states. There also is evidence to show that in states where their use is permissible, they are used with some frequency.[64] Beyond this, there exists the issue of full faith and credit that must be paid by the courts of one state to the judgments of the courts of another state.[65] To the extent that confessions of judgment are entered on the basis of the laws of a state in which they are permissible, they may be [7753] enforceable in other states where they would not otherwise be permissible.

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[62] Alternatively, the differences in survey results may reflect changes in state law or creditor use of cognovits that took place betwen 1973, when the Commission gathered its survey data, and 1977, when the NCFA conducted its survey.

[63] National Commission on Consumer Finance (NCCF), Technical Studies, Vol. 5, Tables 25, 27 (1972).

[64] *See, e.g.*, NCLC survey, *supra* note 54 and accompanying text; Thomas E. Raleigh, Administrator, Collection Agency Act, Illinois, HX-96, Tr. 2433; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2147; Herschel C. Adcock, Louisiana Consumer Finance Association, Tr. 1211; William T. Gwennap, Pittsburgh National Bank, Tr. 12232-34.

[65] For a discussion of the applicability of the full faith and credit clause to cognovit judgments, *see* Hopson, *supra* note 51 at 143-56; Note, *Poverty Law: Judgments by Confession*, 49 Tex. L. Rev. 163, 171 (1970).

On balance it appears that cognovits are prevalent in Pennsylvania and may be used in other states as well, such as Virginia, where they are permitted.[66] Despite the fact that their use has been prohibited or severely restricted in most states, the Commission finds that there is sufficient evidence of continued use of cognovits to warrant a rule addressing that use.

D. Consumer Injury

Although procedures for reopening confessions of judgment exist, the absence of notice and a hearing prior to the entry of the judgment causes significant consumer injury. Cognovit clauses typically are worded in arcane language and may appear in small print.[67] Record evidence supports the conclusion that debtors are unaware that they have agreed to such clauses and that they waive due process rights by doing so.[68] When debtors receive notice of a judgment entered against them, they may not understand its import or that they must act affirmatively to raise any defenses against it.[69] This problem is exacerbated by the fact that many states, including Pennsylvania, do not require notice informing the debtor of the right to contest the judgment or the grounds for

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[66] Record evidence also demonstrates their prevalence in Illinois and Ohio. Cognovits are no longer permitted in these states in consumer transactions, however. Although they are also prevalent in Louisiana, the rule will not prohibit their use in that state. *See infra* notes 103-105 and accompanying text.

[67] Carolyn C. McTighe, Legal Aid Society of Cleveland, R-I(c)-38; Henry J. Sommer, Community Legal Services of Philadelphia, Tr. 10980.

[68] Henry J. Sommer, Community Legal Services of Philadelphia, Tr. 10980, 10989; James D. Morris, Legal Services of Northeastern Pennsylvania, Tr. 9636; Herschel T. Elkins, Office of the Attorney General of California, Tr. 5290; Bernard A. Podcasy, Legal Services of Northeastern Pennsylvania, Tr. 9628; Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3356.

[69] Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11104; Carolyn C. McTighe, Legal Aid Society of Cleveland, R-I(c)-38.

doing so.[70] As a result the debtor may fail to respond despite having valid defenses to the judgment.[71] The rulemaking record shows that judgments entered by confession frequently are invalid on their face.[72] It also shows that debtors frequently have some defense to the judgment.[73]

When debtors are not apprised of their rights and therefore fail to challenge facially invalid judgments or fail to assert valid defenses, the consumer injury is clear. The judgment debtor's property may be taken in satisfaction of a claim that would not survive judicial scrutiny at a hearing on its merits. Loss of this property causes economic hardship, since the debtor loses both its use and any equity in it. Moreover, consumers must replace any essential items that are seized, usually at a greater cost than they were credited with for the seized property. The economic injury, therefore, is substantial.[74]

Alternatively, if they have the resources to do so, consumers may simply pay judgment debts when threatened with

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[70] Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11104. *Compare* Pennsylvania notice requirements, *supra* note 43 and accompanying text, *with* those of Delaware and Virginia, *supra* notes 30-32 and accompanying text.

[71] Henry J. Sommer, Community Legal Services of Philadelphia, Tr. 10980.

[72] In an investigative study of Chicago, Illinois, courts, 377 of 1774 confessed judgments filed during a two-week period in 1960 were invalid. *See* Hopson, *supra* note 51 at 122. Confessions of judgment are no longer permitted in Illinois, but this study demonstrates the potential for abuse that exists in states where they are permitted.

[73] Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11102-03, 11121-22.

[74] *See, e.g., Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11102, Jane Johnson, New Orleans Legal Assistance Corp., Tr. 413. See generally* Karl B. Friedman, Alabama Consumer Finance Association, Tr. 61; William Bellenger, Michigan Department of Licensing and Regulation, Tr. 8178; Tom D. McEldowney, Director, Idaho Department of Finance, Tr. 5056; Andrew Eiler, Consumer Affairs Department, United Auto Workers, R-I(d)-92.

Record evidence indicates that differences exist in the kinds of contracts offered by different creditors. Finance companies in particular are more likely to use the remedies subject to this rule than are other creditors.[10] Among finance companies, use of some contract terms is relatively low when examined nationally. In particular states, however, where certain remedies are more widely used, the incidence is considerably greater.[11] Moreover, within a local area, contracts offered by creditors of a given class may be substantially identical.[12]

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[10] *See generally,* National Consumer Law Center Survey of Credit Contract Practices (1977), HX-467; NCCF Technical Studies, Vol. V (1972). The incidence of particular clauses is discussed in relevant chapters of this statement.

[11] *E.g.,* use of wage assignments is most prevalent in Illinois and New York, *see infra* Chapter V; *use of cognovits is substantially limited to one state—Pennsylvania,* see infra *Chapter IV.*

[12] *E.g.,* Steven P. McCabe, Consumer League of New Jersey, Tr. 8729, R-I(d)-87; Paul J. Pfeilsticker, Continental Illinois National Bank & Trust Co., Tr. 2338; Agnes C. Ryan, Legal Aid Bureau, United Charities of Chicago, Tr. 2244; Drew Johnson, Lane County Legal Aid, Tr. 6305-06; George H. Jones, Association Management Services, R-I(a)-29 at 4; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2155; Michael Burns, Legal Aid Society of Minneapolis, R-I(c)-99; Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11103; Robert Erickson, DNA Legal Services, Tr. 1666; R. A. Stanton, Mid Cities Schools Credit Union, R-I(a)-525; Raphael L. Podolsky, Connecticut Legal Services, R-I(c)-58; Richard Warren, Alabama Lenders Association, R-I(a)-361; Robert Bark, Republic National Bank of Dallas, R-I(a)-872; Stephen Cochran, Bexar County Legal Aid, Tr. 1716; Andrew Eiler, Consumer Affairs Department, United Auto Workers, R-I(d)-92; Hagen McMahen, Independent Bankers Association of Texas, Tr. 1916; Robert Duke, Texas Consumer Finance Association, Tr. 1835; Joe Martin, 1st United Bancorporation, Tr. 1136; Russell Freeman, Security Pacific Bank, R-I(a)-429; *but see* Donald Boudreau, Chase Manhattan Bank, R-I(a)-522.

The strong similarity of consumer credit contracts among creditors of a given kind within a local area limits consumers' incentives to search elsewhere for a better contract.[13] If 80 percent of creditors include a certain clause in their contracts, for example, even the consumer who examines contracts from three different sellers has a less than even chance of finding a contract without the clause.[14] In such circumstances relatively few consumers are likely to find the effort worthwhile, particularly given the difficulties of searching for contract terms discussed below.

A second factor also limits the incentives of consumers to search for better credit contracts. Default is a relatively infrequent occurrence, and most often occurs for reasons that are beyond the control of the borrower.[15] Unlike terms such as interest rates or payments, which are relevant in every transaction, the chances are good that the remedial provisions in any particular transaction will never be relevant. Thus, consumers would quite reasonably concentrate their search for credit on terms such as interest rates and payments, rather than alternative remedial provisions.

Consumers' limited incentives to seek out better contracts are compounded by the costs and difficulties of searching for contract language. Borrowers usually cannot understand the

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[13] George Stigler, in a pioneering article on the subject of search, shows that "if the dispersion of price quotations (among) sellers is at all large (relative to the cost of search), it will pay, on average, to canvass several sellers." In contrast, when price dispersion is small and the cost of information acquisition is high, it will not pay to search for additional quotations. "The Economics of Information," 89 Journal of Political Economy, 171 at 173 (1961). This argument applies, in general, to any information, not just price quotations. If additional search is unlikely to discover a better alternative, it will not pay to engage in additional search.

[14] If 80 percent of creditors chosen at random use a particular term, then the chance that 3 creditors chosen at random all use the term is .8×.8×.8, or 951 percent.

[15] *See infra* Section B.

technical language used in credit contracts.[16] [7747] Some witnesses stated that many provisions are phrased in terms that are virtually impossible for the non-lawyer to understand.[17] As the Presiding Officer noted:

> Consumer credit contracts are not drafted with a view of making the provisions understandable to the consumer generally and do not contain an adequate explanation of either the consumer's rights or the creditor's obligations.[18]

Nor can consumers seek explanations from lenders, because inquiries by prospective customers regarding remedies may tend to make a creditor wary and hesitant to grant the loan.[19] The Presiding Officer concluded "that consumers

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[16] *E.g.*, Professor John Spanogle, Tr. 9714; Dr. Paul E. Smith, Wharton School, on behalf of the National Consumer Finance Association, Tr. 8469; William S. Ballenger, Director, Michigan Department of Licensing and Regulation, Tr. 8177; Kayla Vaughn, Michigan PIRG, Tr. 4648; Karl Friedman, Alabama Consumer Finance Association, Tr. 1466; Professor Eric Wright, University of Santa Clara School of Law, Tr. 8062.

Although debtors may not be able to understand the specific terms of particular contracts, most debtors probably have a reasonably accurate general perception of what is likely to happen to them if they default on their obligations. *See* Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2154-55; Michael Burns, Legal Aid Society of Minneapolis, HX-95 at 5-6. Clarence Naborowski, Illinois Consumer Finance Association, said the great majority of consumers recognize an obligation to pay their debts, Tr. 3845, but they do not read every line of their contracts and, for example, do not know what statutory exemptions are available. Tr. 3878-79.

[17] *E.g.*, Alfred Blakes, North Louisiana Legal Assistance Corporation, HX-50 at 3-4. *See also*, W. Lloyd Copeland, Legal Aid Society, Tr. 2004; David M. Driscoll, El Paso Legal Assistance Society, Tr. 1614-15.

[18] Presiding Officer's Report at 77.

[19] *E.g.*, F. T. Weimer, Sears, Roebuck & Co., R-I(a)-427; Leslie Butler, Consumer Bankers Association, Tr. 11586; James K. Owens, Bank of Gordo, R-I(a)-206 at 3; Keneth V. Larkin, Bank of America, Tr. 5874; Paul J. Pfeilsticker, Continental Illinois Nat'l Bank & Trust Co., Tr. 2337.

do not have a complete understanding of consumer credit contracts." [20] We concur.

Comparing contracts is also complicated by the lack of standardized terminology among various creditors. Different creditors may use different language to achieve essentially the same results.[21] For example, some contracts might refer to a cognovit, which other contracts might describe as a confession of judgment. Particularly given the complex legal terminology often employed, many consumers may find it difficult even to identify substantive differences in contracts. In some cases, comparison is impossible because the creditor refuses to give out the loan contract until the borrower seems ready to sign it.[22]

In many other markets when comparing products is difficult for shoppers, companies attempt to make such information more easily accessible. Companies with more favorable remedial terms have an incentive to advertise that fact, and thereby attract a larger share of the loan market.[23] No such advertising is reflected in the record, however. Nor does the rulemaking record have specific information on why such advertising fails to occur. Nevertheless, the Commission sees several possible explanations, including those discussed above: the complexity of the legal process surrounding remedies and the fact that the average consumer does not focus on elements of a transaction that are distant in time and probability.

Consumer ignorance with regard to the meaning of contractual language is one factor that may inhibit such advertising.

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[20] Presiding Officer's Report at 77.

[21] *E.g.*, R-XI-164, 165, 187, 191-193, 195; *see generally*, consumer credit contracts, R-XI-[name of company], in binders 215-42-1-12-36 through 294.

[22] *See* Jonathan Epstein, Essex-Newark Legal Service, Tr. 8945; Toby J. Rothschild, Legal Aid Foundation of Long Beach, HX-264 at 1.

[23] In general, "sellers have a substantial economic incentive to disseminate information to consumers." *See, e.g.*, Beales, Craswell, and Salop, *supra* note 9, at 491, 502.

For example, the company that claims that its contract contains no waiver of exemption will have to explain what a waiver is, and why consumers should prefer a contract without it. Such an educational campaign is costly and will tend to benefit other creditors who "free ride" on the company's efforts.[24] If consumers prefer contracts without waivers, then other companies can eliminate their waivers (and advertise the fact) without bearing the costs of education.

Adverse selection by borrowers also limits the incentives of creditors to promote remedies that are relatively lenient. Within any group of borrowers that appear identical to the creditor, the true default risk for some is greater than others. If a creditor were to introduce a loan contract with less onerous remedies than those of its competitors, then its contract would become especially attractive to relatively high risk borrowers, because these borrowers have the most to gain from the more lenient remedy terms. Therefore, a disproportionately greater share of the borrowers attracted to this company would be those with a relatively high risk of default.[25] Thus, a company that promoted more lenient remedy terms might experience a higher rate of borrower default than its competition. Unless its higher rate of interest could fully compensate for this higher rate of default, the company would find these remedy provisions unprofitable, even if consumers would prefer the provisions.

Ultimately, similar considerations led the Commission to reject an alternative rule that would have required plain English disclosure of contractual remedies. Such a rule would make information more easily accessible to borrowers. However, in so doing it would tend to exacerbate the adverse selection problem. Moreover, disclosure alternatives would deal only partially with limited seller incentives to promote alternative remedies due to the free rider problem, and would

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[24] The free rider problem can lead to an underprovision of information. *Id.* at 503-505.

[25] Aho, *et al.*, The Federal Trade Commission Proposals for Credit Contract Regulations and the Availability of Consumer Credit, R-XI-10 at 129.

not address at all consumers' limited incentives to search for information about remedies.[26]

Although some options exist, and some consumers may search for contract provisions they prefer, the record indicates that in consumer credit markets, comparison of competing contracts is difficult and costly. Moreover, remedies intended to reduce the costs of identifying better contracts are unlikely to succeed. Therefore, the Commission has concluded that consumers cannot reasonably avoid the contract clauses at issue in this proceeding.

B. Default and its Causes

Even if a contract contains undesirable remedies, borrowers could reasonably avoid injury if they could avoid implementation of remedies. Addressing this possibility requires an examination of the causes of default.

There are two leading studies of the causes of default, one by the National Commission on Consumer Finance[27] and the other by sociologist David Caplovitz.[28] The studies complement each other—the NCCF relied on survey data from creditors but Caplovitz surveyed debtors. Both reach similar conclusions.

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[26] For a fuller discussion of the disclosure alternative see Chapter XIII.

[27] NCCF Technical studies, Vol. V, at 5 (1972).

[28] David Caplovitz, *Consumers in Trouble: A study of Debtors in Default* 54 (1974).

"Loss of income" stands out as the leading reason for default in the Caplovitz study.[29] The primary causes of loss of income are "adverse employment change" (including unemployment, loss of overtime, etc.) and "illness to chief wage earner." [30] Findings of the NCCF are similar. Unemployment is ranked as the most important cause of default by all classes of creditors. Overextension is found to be the second most

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[29] Caplovitz' results are summarized as follows:

MAJOR CATEGORIES OF REASONS FOR DEFAULTS

(percent)

	1st reason	2nd reason	3rd reason	Total reason	Total*
Debtors mishaps and shortcomings:					
Loss of income . . .	43	18	10	24	48
Voluntary over-extension	13	23	32	17	25
Involuntary over-extention	5	12	7	7	11
Marital instability .	6	4	5	5	8
Debtor's third parties	8	4	6	6	9
Debtor irresponsibility . . .	4	2	.....	4	6
Creditor may be implicated:					
Fraud, deception . .	14	13	15	14	19
Payment misunderstandings	7	3	.....	6	8
Partial late payments	.....	15	6	5	7
Item returned to creditor	(**)	6	14	2	4
Harassment by creditor	.....	1	5	1	1
All other (miscellaneous) . .	1	.....	.....	(**)	(**)
Total percent	101	101	100	101	146
N	(1,320)	(570)	(110)	(2,000)	(1,328)

* Total individuals giving reason as percent of total number of individuals in study.

** Signifies less than ½ of 1 percent.

Id. at 53.

[30] *Id.* at 58. "Adverse employment change" was the primary reason for about half of the income loss in the study, while illness counted for another third.

important cause by banks and finance companies, and the third most important cause by retailers.[31]

These categorizations are necessarily somewhat imprecise.[32] Nevertheless, the results indicate that the precipitating cause of default is usually a circumstance or event beyond the debtor's immediate control. When such events occur, default is generally an involuntary response. [7748]

Nonetheless, among a minority of debtors, default might have been prevented. Caplovitz found voluntary overextension was given as either a major or contributing cause of default by 25 percent of the debtors surveyed and debtor

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[31] More complete results can be found in the following table:

MAJOR REASONS CREDITORS REPORT HAVE CAUSED DEBTORS TO FAIL TO MEET CONTRACTUAL OBLIGATIONS

Major reasons	Banks (796 responses)	Finance companies (218 responses)	Retailers (141 responses)
Unemployment	1	2	1
Overextension	2	2	3
Illness of debtor	3	3	2
Separation	4	4	4
Illness in family of debtor	5	6	6
Divorce	6	5	5
Lack of intention to repay—"deadbeat"	7	8	7
Family relocation	8	7	8

See: NCCF Technical Studies, Vol. V, *Supra* note 27, at 9.

[32] For example, Caplovitz interviewed debtors in default and asked: "What were the main reasons why you stopped making payments on the (merchandise/loan)?" A typical response was: "I got sick and didn't work for a while and there were too many bills to keep up." Is the cause of this default involuntary overextension or illness? Such distinctions are difficult to make and Caplovitz acknowledges that his coding decisions "were to some extent arbitrary." D. Caplovitz, *supra* note 28, at 49-51. In addition, there may be response bias as debtors may tend to underestimate their own responsibility in causing default.

irresponsibility by 5 percent.[33] The NCCF found overextension to be the second or third most important cause of default (no distinction was made between voluntary and involuntary overextension) and lack of intention to repay as the last or next to the last most important cause of the 8 causes studied.[34] Moreover, some debtors can engage in precautionary behavior that will soften the impact of unfortunate events, and enable them to increase their chances of weathering adversity without defaulting on their obligations.[35]

One study on the record provides some insight in this regard. It examines the incidence of seven economically traumatic events in a representative sample of American families over a five-year period. Events studied were firings, unemployment, underemployment, evictions, unplanned emergency expenditures, unplanned children, and illness resulting in two or more weeks absence from work. The study found that over a five-year period almost all households experience at least one of the listed events. A majority experience four or more.[36]

Default, however, is a far less common experience. Data on automobile loans, for example,[37] indicates a yearly default rate which fluctuates between 3 and 6 percent, depending on

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[33] *See supra* note 28.

[34] *See supra* note 31.

[35] For example, one witness stated that a major cause of default with respect to automobile loans was the uninsured collision. He added that if the car had been insured when damaged, repairs would have been made at the expense of the insurance company, and there would have been no default. Curtis R. McCalin, Northeast Ford, Tr. 11531-32.

[36] Data were taken from the "Panel Study of Income Dynamics," a continuing longitudinal study project of the University of Michigan Survey Research Center, R-XIII-4 at 6-8; and from E. Ehrlich, *Involuntary Disruptions of "Life-Cycle" Plans*, in *Five Thousand American Families—Patterns of Economic Progress, Analyses of the First Six Years of the Panel Study of Income Dynamics*, Vol. III (G. Duncan and J. Moran, eds. 1975).

[37] Reliable data for overall default rates are not available.

the general state of the economy.[38] Robert Shay, Columbia University Business School, testified for NCFA that at any given time about 7 percent of finance company accounts were 60 or more days past due.[39] He suggested that these borrowers are most likely to be subject to creditor remedies.[40] Creditors other than finance companies have lower delinquency rates than do finance companies.[41]

Although most consumers do not default, many defaults nonetheless occur. Moreover, the record demonstrates that among those defaults that occur, the majority are not reasonably avoidable by consumers. Instead, default is a response to events that are largely beyond the consumer's control. Precautions can reduce the risk of default, but no reasonable level of precautions can eliminate the risk. Moreover, some consumers are unable to take various precautionary steps.[42] Thus, consumers cannot reasonably avoid the harsh consequences of creditors' remedies by avoiding default.

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[38] American Bankers Association (ABA) Installment Lending Division, "Delinquency Rates on Bank Installment Loans", various years. *See also*, R-XI-16; R-I(a)-816 at 48; R-I(a)-812 at 5.

[39] HX-494 at 24.

[40] *Id.* at 23. These figures may, however, understate the number of consumers who become delinquent during the term of a credit obligation. Thus, Robert Mallock of Beneficial Management Corporation testified that about 30 percent of Beneficial accounts become delinquent in the course of a year. Tr. 9580.

[41] As of the end of 1978, federal credit unions had an over 60 day delinquency rate of 3.7 percent of the number and 2.2 percent of the amount of loans outstanding. 1978 Annual Report of the National Credit Union Administration at 7-8. In the third quarter of 1978, bank installment loan 30 days delinquent rates were about 2.4 percent, down from a high of slightly over 3 percent at the beginning of 1975. ABA, "Delinquency Rates of Bank Installment Loans," (Bulletin No. 405, Third Quarter 1978), based on weight average of eight loan types. Personal loan delinquency rates were somewhat higher, at about 3.1 percent in the third quarter of 1978.

[42] *See., e.g.*, Renee H. Reixach, Greater Upstate Law Project, XV-315 at 1155; Joanne S. Faulkner, New Haven Legal Assistance Association, Inc., XV-150 at 395.

IV. Confessions of Judgement

Section 444.2(a)(1) of the rule provides that it is an unfair act or practice for a lender or retail installment seller to take or receive from a consumer an obligation that consitutes or contains a cognovit, confession of judgment (for purposes other than executory process in the state of Louisiana),[1] warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon.

A. Nature of the Practice

The cognovit is a legal device whereby the debtor, by means of a provision included in the contract, consents, in advance to the creditor obtaining a judgment without prior notice or hearing. The debtor either confesses judgment in advance of default or authorizes the creditor or an [7749] attorney designated by the creditor to appear and confess judgment against the debtor.[2] Unless the contract so provides, default is not a necessary condition precedent to the entry of judgment. The judgment may be taken by any person holding the note. At common law it operates to cut off the opportunity to contest jurisdiction or venue or to present any claims or defenses that the debtor may have.[3] Judgment is rendered for the amount due shown on the face of the note plus any other charges authorized, such as attorney fees and any court costs. It can

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[1] The exception provided for Louisiana is discussed *infra* at notes 103-105 and accompanying text.

[2] A warrant of attorney authorizing judgment is perhaps the most powerful and drastic document known to civil law. The signer deprives himself of every defense and every delay of execution, he waives exemption of personal property from levy and sale under the exemption laws, he places his cause in the hands of a hostile defender. The signing of a warrant of attorney is equivalent to a warrior of old entering a combat by discarding his shield and breaking his sword.

Cutter v. *Latshaw*, 374 Pa. 1, 4-5, 97 A.2d 234, 236 (1953).

[3] *Jones* v. *John Hancock Mut. Life Ins. Co.*, 289 F. Supp.930, 935 (W.D. Mich. 1968), *aff'd*, 416 F.2d 829 (6th Cir. 1969). *See also*, Presiding Officer's Report at 79.

be converted into a lien on the debtor's property, which subjects debtor's property to seizure and sale to satisfy the judgment.

Because the common law cognovit is a drastic remedy, its use today typically is constrained to some extent by statutory safeguards in those states where it is permitted and used. In such states, as at common law, judgment is entered against the debtor by the filing of a confession. The filing creates a lien on the debtor's property, subjecting it to execution in satisfaction of the debt. Unlike its operation at common law, however, the entry of judgment does not cut off all opportunity to contest the creditor's claim. The judgment debtor has the right to petition the court and, if the debtor presents a prima facie case, the court will reopen the judgment.[4] The debtor may then raise any substantive defenses to the creditor's claim that could have been used in the debtor's defense in a trial on the merits.[5] The lien of the judgment or of any levy or attachment is preserved while these proceedings are pending.

Although such statutory safeguards provide debtors with some means of protecting their property interests, they fail to provide the full due process protection required by the fourteenth amendment to the Constitution. The essence of the due process clause as it relates to property is to protect the individual from wrongful deprivation by, or through the offices of, the government.[6] Such protection is achieved by

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[4] This discussion of statutory safeguards reflects the law governing confessions of judgment in Pennsylvania, *see infra* notes 33-45 and accompanying text. In other states, procedural safeguards governing the use of cognovits are similar but variations exist. *See, e.g.*, discussion of statutory safeguards in Delaware and Virginia *infra* notes 29-32 and accompanying text.

[5] Absent a defense, however, judgment will not be reopened merely because the debtor has a counterclaim or set-off that he could have joined with his defense. *J.M. Korn & Son, Inc.* v. *Fleet Air Corp.*, 300 Pa. Super. 458,--,446 A.2d 945, 947 (1982). Additional limits on the debtor's right to a trial de novo are discussed *infra* at notes 43-47 and accompanying text.

[6] *Fuentes* v. *Shevin*, 407 U.S. 67, 81 (1972).

giving individuals notice of the claims against them,[7] and the opportunity to contest those claims at a hearing.[8] If the hearing is to achieve its purpose, then, in anything other than an emergency situation it must precede the property deprivation.[9]

Judgment debtors whose property is encumbered through the existence of a creditor's lien lose the full use and enjoyment of their property. Debtors are unlikely to be able to sell it, for example, or to use it as collateral while it is subject to a lien. Although the debtor may eventually prevail on the merits and dissolve the lien, the post-judgment rights provided by statute cannot cure the deprivation experienced while the action is pending. Even a temporary and non-final deprivation of the use of one's property is a matter of constitutional significance and invokes the protection of the due process clause.[10] Because state statutory protections governing cognovits arise only after debtors are deprived of the full use of their property, they cannot guarantee full due process protection. The right to a hearing before deprivation occurs is essential.[11]

The contractual waiver of one's right to due process is constitutionally permissible, provided that the waiver is made voluntarily, knowingly, and intelligently.[12] Thus, in a commercial context, the use of confessions of judgment has been upheld where the facts demonstrated that this standard had been met.[13] A consumer who is unaware of the existence or meaning of a cognovit clause, however, cannot be said to

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[7] *Baldwin* v. *Hale*, 66 U.S. (1 Wall.) 223, 233 (1863).

[8] *Grannis* v. *Ordean*, 234 U.S. 385, 394 (1914).

[9] *Fuentes* v. *Shevin*, 407 U.S. 67, 81 (1972); *Bell* v. *Burson*, 402 U.S. 535, 542 (1971).

[10] *Sniadach* v. *Family Finance Corp.*, 395 U.S. 337, 342 (1969); *North Georgia Finishing* v. *DiChem, Inc.*, 419 U.S. 606 (1975).

[11] *See Fuentes* v. *Shevin*, 407 U.S. 67, 81 (1972).

[12] *Compare Overmeyer* v. *Frick*, 405 U.S. 174, 187 (1971) *with Swarb* v. *Lennox*, 405 U.S. 191 (1971).

[13] *See Overmeyer* v. *Frick*, 405 U.S. 174 (1971).

have waived due process rights voluntarily, knowingly, and intelligently by signing a contract that includes such a clause.[14]

Of the creditor remedies addressed by the rule, confessions of judgment are least likely to be understood by consumers.[15] In many cases, consumers, especially low-income consumers, are not aware that cognovit clauses are in their contracts.[16] To the extent that they are aware, consumers rarely understand the significance of these clauses because they are worded in obscure technical language and because the concept of judgment by confession conflicts with the common understanding of basic due process rights.[17] The record shows that, for these and other reasons (discussed in Chapters II and III above), consumers do not bargain over this provision or shop for contracts without it. The Commission finds, therefore, that consumers cannot reasonably avoid the injury caused by cognovits.

B. State Law

Virtually all states currently impose some statutory restrictions on the use of cognovit clauses. The protection that such statutes provide is far from uniform, however. A number of states either bar the use of confessions of judgment altogether or prohibit their use in connection with any claim arising out

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[14] *See Swarb* v. *Lennox*, 405 U.S. 191, 197-98 (1972). State statutes governing confessions of judgment do not generally provide for a hearing on the question of waiver. *But see* Del. Code Ann. Tit. 10, section 3906 (1974), which does provide for such a hearing.

[15] Presiding Officer's Report at 90.

[16] *See Swarb* v. *Lennox*, 405 U.S. 191, 197 (1972); *Id.* at 196 (citing a 1968 study conducted by David Caplovitz of 245 confessed-judgment debtors in Philadelphia, only 14 percent of whom knew that the contracts they had signed contained cognovit clauses).

[17] *E.g.*, Carolyn C. McTighe, Legal Aid Society of Cleveland, R-I(c)-38; Jules S. Littman, Middlesex County Legal Service Corporation, R-I(c)-28 at 3; Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3356.

in or affecting commerce, are hereby declared unlawful.[7]

The Commission's authority to prohibit unfair acts or practices in the marketplace is well established.[8] The Commission and the courts have developed an extensive body of law concerning unfair practices.[9][7743]

The Wheeler-Lea amendment of 1938, the 1975 and 1980 FTC Improvements Acts, and pending legislation in the Congress constitute legislative recognition that, in an imperfect system, certain commercial practices may impose undue costs and risks on individuals, depriving them of the benefits normally associated with free and vigorous competition.[10] In this proceeding, the Commission is exercising its unfairness jurisdiction to determine whether in the consumer credit market there is a market imperfection that is preventing a balancing of costs and benefits to individuals. This proceeding examines the market to determine whether it ensures an efficient allocation of cost and risk between consumers and those who extend credit to them. It is our conclusion that the practices addressed by this rule, as discussed individually in Chapters

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[7] 15 U.S.C. 45 (Cum. Supp. 1983).

[8] When Congress created the Commission's unfairness authority, it deliberately framed that authority in general terms. Congress felt that any attempt to list all "unfair * * * acts or practices" could leave loopholes for evasion of the law. Also, Congress did not intend the meaning of "unfair" to be static. It was expected that the underlying criteria would evolve and develop over time. For a comprehensive discussion of the generality of Section 5, see Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, 43 FR23992, 24000 (1978).

[9] *See generally, FTC* v. *R.F. Keppel Bros.*, 291 U.S. 304, 313 (1934); Statement of Basis and Purpose, Trade Regulation Rule for the Prevention of Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, 29 FR 8324, 8355 (1964); *All States Industries Inc.* v. *F.T.C.*, 423 F. 2d. 423 (4th Cir.), *cert denied*, 400 U.S. 828 (1970); *FTC* v. *Sperry & Hutchinson Co.*, 405 U.S. 233 244-45 n. 5 (1972); Statement of Basis and Purpose, Preservation of Consumers' Claims and Defenses, 40 FR 53506, 53522 (1975); *Spiegel, Inc.*, 88 F.T.C. 425 (1975), *aff'd in part*, 540 F. 2d 287 (7th Cir. 1976).

[10] *See, e.g., Horizon Corporation*, 97 F.T.C. 464 (1981).

IV-IX, are within the parameters of unfairness under Section 5.

In December 1980, the Commission prepared a formal statement analyzing the legal basis for the exercise of its Section 5 consumer unfairness jurisdiction.[11] That document reviewed the Commission's prior exercise of its unfairness jurisdiction and clarified the criteria for its future use of this authority.

Consumer injury is the central focus of any inquiry regarding unfairness. Not every instance of consumer injury is unfair, however, because virtually any commercial practice involves a complex mix of benefits and costs. In its statement, the Commission observed that:

> To justify a finding of unfairness the injury must satisfy three tests. It must be substantial; it must not be outweighed by any countervailing benefits to consumers or competition that the practice produces; and it must be an injury that consumers themselves could not reasonably have avoided.[12]

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[11] *See* Letter from the Commission to the Honorable Wendell H. Ford and the Honorable John C. Danforth (Dec. 17, 1980) (hereinafter cited as "Commission Unfairness Statement"). *See also Horizon Corporation*, 97 F.T.C. 464 (1981); Letter from the Commission to the Honorable Bob Packwood and the Honorable Bob Kasten (March 5, 1982) (hereinafter cited as "Commission Letter").

[12] *See* Commission Unfairness Statement, *id.* The 1980 Commission Unfairness Statement is entirely consistent with the legal theory which we enunciated in the 1975 initial notice of rulemaking for this proposal. We indicated that relief under Section 5 would be appropriate if:

> (1) The creditor imposes upon consumers contracts of adhesion (i.e., the credit customers cannot bargain over the particular contract provisions) which contain provisions disadvantageous to consumers or the creditor fails to include in the contracts of adhesion provisions beneficial to consumers, all to the consumers' detriment; and
>
> (2) This detriment to consumers is not offset by a reasonable measure of value received in return.
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> 440 FR 18349 (1975)

[footnote continued]

Pending legislative proposals would give Congressional recognition to this unfairness standard:

> An act or practice in or affecting commerce shall be considered to be an unfair act or practice * * * if—
>
> (i) Such act or practice causes or is likely to cause substantial injury to consumers; and
>
> (ii) Such substantial injury (I) is not reasonably avoidable by consumers; and (II) is not outweighted by countervailing benefits to consumers or to competition which result from such practice.
>
> Any determination under the preceding sentence regarding whether an act or practice is an unfair act or practice shall take into account, in addition to other relevant factors, whether such act or practice violates any public policy as established by Federal or State statutes, common law, practices in business or industry, or otherwise.[13]

The Commission's unfairness authority does not extend to trivial or speculative harm. "An injury may be sufficiently substantial, however, if it does a small harm to a large number of people, or if it raises a significant risk of concrete harm."[14] Furthermore, except in aggravated cases where tangible injury can be clearly demonstrated, subjective types of harm—embarrassment, emotional distress, etc.—will not be enough to warrant a finding of unfairness. Rather, economic or other tangible harm must also be present.[15]

These are, of course, the same elements—reasonable avoidance and countervailing benefits—as those identified (albeit in different language) in the 1980 statement.

[13] H.R. 2970, 98th Cong., 1st Sess. This proposed legislation is supported by the Commission and a majority of the commissioners have endorsed its incorporation into the FTC Act.

[14] Commission Unfairness Statement, *supra* note 11.

[15] *Id.*

Earlier articulations of the consumer unfairness doctrine have also focused on whether "public policy" condemned the practice in question.[16] In its December 1980 statement, the Commission stated that it relies on public policy to help it assess whether a particular form of conduct does in fact tend to harm consumers.

We have thus considered established public policy "as a means of providing additional evidence on the degree of consumer injury caused by specific practices."[17] By "established" public policy, we mean that: (i) The policy is embodied in "formal sources" such as constitutions, statutes, or judicial decisions, and (ii) it is widely shared by a number of states.[18] This is especially true concerning court decisions involving constitutional rights, such as due process guarantees. Where public policy appears to be in conflict, the Commission will "reconsider its assessment of whether the practice is actually injurious in its net effects."[19] The Commission has applied this standard to the creditor practices prescribed by this rule.

In short, consumer injury is the central element in a finding of unfairness. But not every instance of consumer injury will lead to a determination of unfairness. The injury must be found to be substantial, not reasonably avoidable by the consumer, and not outweighed by countervailing benefits to consumers or competition. The record as it relates these criteria to each rule provision will be reviewed in the respective chapters of this statement addressing each rule provision. Chapter III of this Statement contains an examination of the record as

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[16] *See, e.g.*, Statement of Basis and Purpose, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, 29 FR 8324, 8355 (1964); *FTC v. Sperry & Hutchinson*, 405 U.S. 233, 244-45 n.3. (1972).

[17] Commission Unfairness Statement, *supra* note 11, at 9. *See also* Commission Letter, *supra* note 11 at 3 "A thorough analysis of such [established public] policies 'can serve as an important check on the overall reasonableness of the Commission's action.' "

[18] Commission Unfairness Statement, *supra* note 11, at 12.

[19] *Id.* at 10.

it relates to the general question of reasonable avoidance by consumers of creditor remedies. The balance of this Chapter presents an overview of the remaining unfairness criteria as they relate to the rule.

C. Unfairness in Creditors' Contractual Remedies

1. Substantial Injury

The rulemaking record documents substantial consumer economic or monetary injuries from the use of these creditor remedies. For example, confessions of judgment cause injury by depriving consumers of notice of a suit or hearing and the opportunity to appear and present any meritorious claims or defenses. Once obtained, the confessed judgment can be turned into a lien on the consumer's real and personal property.[20] If the contract also contains [7744] a waiver of exemption clause, the consumer can lose the basic necessities of life. This would require that the debtor replace these items or face destitution, and the possibility of becoming a public charge.[21] Blanket security interests in household goods also present this possibility.[22]

A wage assignment also occurs without the due process safeguards of a hearing and an opportunity to assert defenses or counterclaims. For consumers who may have valid reasons for nonpayment, the injury inherent in the denial of due process protections can be severe. It can lead to job loss, or severely reduced income, either one of which could prevent the consumer from providing for his or her family or cause default on other obligations.[23]

Pyramiding of late charges results in the consumer being unknowingly assessed multiple late charges for a single late payment, even though subsequent payments are timely

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[20] *See infra* Chapter IV.

[21] *See infra* Chapter VII.

[22] *See infra* Chapter VI.

[23] *See infra* Chapter V.

made. The multiple late charges can add up to 60 percent annual percentage rate in many cases.[24]

The rulemaking record establishes by a preponderance of the evidence that consumers suffer substantial economic or monetary injury from creditors' use of these practices. This is the primary focus of our unfairness analysis. Although our unfairness standard makes it a subsidiary consideration, the record shows that consumers often suffer substantial emotional or subjective harm as well. For example, wage assignments invade the consumer's right of privacy, causing embarrassment and humiliation, without a judicial determination of the validity of the creditor's claim. Although such subjective harm is not easily quantifiable, it is clear that consumers value measures to protect them from such injury.

In assessing particular remedies, our focus has been on the consequences of these remedies for consumers in those cases when the remedy is invoked or threatened. Nonetheless, all consumers will benefit from the rule to the extent that it reduces the adverse consequences of default because it serves, in that capacity, as a form of insurance. At the time a consumer enters into a loan agreement, the likelihood of default is both remote and difficult to assess. Thus, all consumers face some risk of default and will value insurance which reduces the most injurious consequences of default, even if they never need the insurance.[25] In this sense, all consumer debtors will benefit.

2. Not Reasonably Avoidable

A violation of the Section 5 unfairness standard will almost always reflect a market failure or market imperfection that prevents the forces of supply and demand from maximizing

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[24] *See infra* Chapter VIII.

[25] The insurance thus provided is not costless, of course, and some consumers may prefer not to purchase it. The costs are discussed in this Chapter, *see infra* Section 3: Countervailing Benefits, and, to the extent that they can be identified for each of the individual rule provisions, in the "offsetting benefits" section of Chapters IX-X.

benefits and minimizing costs. Normally, we can rely on consumer choice to govern the market. In considering whether an act or practice is unfair, we look to whether free market decisions are unjustifiably hindered.

In consumer credit transactions, the rights and duties of the parties are defined by standard-form contracts, over most of which there is no bargaining. The economic exigencies of extending credit to large numbers of consumers each day make standardization a necessity. The issue, however, is whether the contents of these standard form contracts are a product of market forces.

Although market forces undoubtedly influence the remedies included in standard form contracts, several factors indicate that competition will not necessarily produce optimal contracts. Consumers have limited incentives to search out better remedial provisions in credit contracts. The substantive similarities of contracts from different creditors mean that search is less likely to reveal a different alternative. Because remedies are relevant only in the event of default, and default is relatively infrequent, consumers reasonably concentrate their search on such factors as interest rates and payment terms. Searching for credit contracts is also difficult, because contracts are written in obscure technical language, do not use standardized terminology, and may not be provided before the transaction is consummated. Individual creditors have little incentive to provide better terms and explain their benefits to consumers, because a costly education effort would be required with all creditors sharing the benefits. Moreover, such a campaign might differentially attract relatively high risk borrowers.[26]

For these reasons, the Commission concludes that consumers cannot reasonably avoid the remedial provisions themselves. Nor can consumers, having signed a contract, avoid the harsh consequences of remedies by avoiding default. When default occurs, it is most often a response to events

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[26] *See infra* Chapter III, Section A.

such as unemployment or illness that are not within the borrower's control.[27] Thus, consumers cannot reasonably avoid the substantial injury these creditor remedies may inflict.

3. Countervailing Benefits

These creditor practices involve a mixture of costs and benefits, both economic and social. An individual creditor practice will not be considered to be unfair unless it is injurious in its net effects.[28] The potential costs include burdens such as "increased paperwork, increased regulatory burdens on the flow of information, reduced incentives to innovation and capital formation, and similar matters."[29]

The potential costs of most significance in this proceeding include increased collection costs, increased screening costs, larger legal costs, and increases in bad debt losses or reserves. Increased creditor costs generally would be reflected in higher interest rates to borrowers, reduced credit availability, or other restrictions such as increased collateral or larger down payment requirements.[30]

The possible magnitude of these costs is diminished by the fact that the rule leaves untouched a wide variety of more valuable creditor remedies. Remedies such as repossession, suit, garnishment, acceleration and direct contacts, which are

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[27] *See infra* Chapter III, Section B.

[28] *See Pfizer, Inc.*, 81 F.T.C. 23, 62-63 n.13 (1972); Statement of Basis and Purpose, Disclosure Requirements and Prohibitions Concerning Franchising the Business Opportunity Ventures, 43 FR 59614, 59636 n.95 (1978). When making this determination, the Commission may refer to existing public policies for help in ascertaining the existence of consumer injury and the relative weights that should be assigned to various costs and benefits. The role of public policy in unfairness determinations will be discussed more generally below.

[29] Commission Unfairness Statement, *supra* note 11, at 7.

[30] *E.g.*, Walter E. Huizenga, National Automobile Dealers Association, R-II (g)-419; Helmut Schmidt, Transamerica Finance Association, Tr. 8187-88.

highly valued by creditors,[31] are not affected by this rule. Thus, for example, the impact of restrictions on wage assignments is limited, given the availabilty of garnishment to allow creditors to reach a debtor's income. The remedies subject to the rule must be evaluated in light of their more limited incremental contribution to deterring [7745] default or reducing other creditor costs, given remedies that remain available.

The action we take today based on this record is premised on our finding that the cost of each rule proposal is lower than the costs, to consumers and competition, of the specific practices at which the rule is aimed. For the provisions we adopt, record evidence establishes that the action we take will provide benefits to consumers in excess of any costs. In other cases, the record does not justify the action originally proposed.[32]

To the extent that the remedies that the rule prohibits reduce the cost of business for creditors, borrowers as a group benefit from those remedies through greater availability of credit and lower interest rates. However, the Commission believes the overall costs to consumers are greater than these benefits.[33]

D. Legal Format of the Rule

We have adopted certain text changes to bring this rule into accord with the decision in *Katharine Gibbs School v. FTC*[34] (hereinafter *Gibbs*) which requires a rational connection between the practice found to be violative of Section 5 and the prescribed remedy. In order to make this connection clear, the Second Circuit held that the Magnuson-Moss Act

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[31] *E.g.*, *Consumer Credit in the United States*, Report of the National Commission on Consumer Finance (NCCF) at 44 (1972); NCCF Technical Studies, Vol. V, at 118-127, 151-153 (1973).

[32] We have deleted, therefore, the provisions concerning deficiency balances, attorneys' fees, cosigners (other than the disclosure notice to cosigners), third party contacts, and cross collateralization.

[33] See *infra* Chapter X.

[34] 812 F.2d 658 (2d Cir. 1979).

requires the Commission to set forth in the actual text of a rule a description of the underlying unfair or deceptive acts or practices which serve as its basis.

Most of the provisions of this rule require the elimination or restriction of specified contractual terms and conditions,[35] or of identified accounting procedures.[36] The rule defines the use of such clauses or procedures, *in se*, to be an unfair practice. Because in these instances the direct relationship between the unfair practice and the proscription of that practice is apparent on the face of each such provision, there is no reason to set out the two separately.

The only provision to which this analysis does not apply is the requirement of a cosigner disclosure notice in § 444.3. In order to comply with the *Gibbs* ruling, we have modified this section to, first, define the unfair or deceptive practices (misrepresentation of and failure to disclose the nature or extent of cosigner liability) and, second, prescribe the remedy (furnishing the required notice). We believe this language meets both the statutory requirement that the unfair practice be described with specificity and the *Gibbs* imperative that the identified prescription be rationally related to the defined unfair practice.

E. Regulatory Analysis

Based on unfairness, the legal theory for this rule requires the Commission to examine the benefits and costs of each rule provision to conclude that the practice at issue violates Section 5. This analysis is no different than that embodied in the statutory requirement to conduct a regulatory analysis.[37] For this reason, the Commission has integrated the regulatory analysis with the Statement of Basis and Purpose for the rule.

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[35] Section 444.2(a) (1) through (4).

[36] Section 444.4.

[37] Section 22 of the Federal Trade Commission Act, as amended, 15 U.S.C. 57b-3. The statutory authority specifically provides for integrating the regulatory analysis with the Statement of Basis and Purpose. *See FTC Act section 22(b)(3)(A)(ii).*

A regulatory analysis for the sections of the original proposal that the Commission decided not to promulgate is included in Chapter XIII.

III. Evidentiary Basis for the Rule as a Whole

As discussed in the preceding chapter, there are three elements in the Commission's consideration of whether the consumer injury associated with a practice reaches the level of legal unfairness. To justify a finding of unfairness, the injury must be substantial, not outweighed by countervailing benefits to consumers or competition, and not reasonably avoidable by consumers.

This chapter discusses our rationale and the evidence relating to the third element—the degree to which injury is reasonably avoidable by consumers. The ability to avoid injury depends in part on whether consumers have access to loan contracts without the provisions in question, and in part on whether, having signed a contract containing these provisions, consumers can avoid their implementation. Our analysis deals with the rule as a whole. Discussion of record evidence pertaining to specific provisions is reserved for subsequent chapters.

A. The Market for Creditors' Remedies

In part, consumers' ability to avoid certain remedies depends on their ability to shop and compare the language of different credit contracts. To the degree consumers cannot reasonably obtain contracts without certain provisions, they must accept those provisions if they want a loan.

The record shows that although consumers may be able to bargain over terms such as the price of credit and the number

or size of payments, [1] there is no bargaining over the boilerplate contract terms that define creditor remedies. [2] We concur with the Presiding Officer's finding that creditors:

> Universally make use of standardized forms in extending credit to consumer. These forms are prepared for creditors or obtained by them, and the completed contract is presented to the prospective borrower on a "take it or leave it basis".[3]

The consumer credit industry, government officials, legal aid attorneys, and academics concurred with this finding.[4][7746]

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[1] *E.g.*, Gerald Kell, Board of Governors, Federal Reserve System, HX-450 (summarizing bank comments); Paul Stansbury, Valley National Bank, R-I(a)-384.

[2] *E.g.*, Clare Rollwagen, Minnesota Consumer Finance Conference, Tr. 3928; Richard Halliburton, Legal Aid & Defender Society of Kansas City, Tr. 114; Jane Johnson, New Orleans Legal Assistance, R-I(c)-101; Eugene Thirolf, Land of Lincoln Legal Assistance R-I(c)-20; Paul Smith, Pennsylvania CFA, Tr. 8469; Eric Wright, Santa Clara Law School, Tr. 8059; Sam Kelly, Texas Consumer Credit Commissioner, Tr. 1293. Michigan Bankers Association, R-I(a)-181; Robert Cobrann, Delta Bank and Trust Co., R-II(c)-5; Leslie Butler, Consumer Bankers Association, Tr. 11586; Robert Mallock, Beneficial Finance Company, Tr. 9578; "Remedial and security provisions seem to be standard from one lender to another, and the market very possibly would not reflect bargaining for these provisions since lenders do not compete for delinquent accounts." Royal White, Mississippi Consumer Finance Association, Tr. 207.

[3] Presiding Officer's report at 61.

[4] *E.g.*, *Bankers:* Alfred Lapan, Massachusetts Cooperative Bank League, Tr. 11481; Paul Pfielsticker, Cont. Illinois Bank & Trust, Tr. 2337; Russel Friedman, Security Pacific Co., R-I(a)-429; Joe Martin, 1st United Bancorporation, Tr. 1132; Hagen McMahan, Independent Bankers of Texas, Tr. 1916; Donald Boudreau, Chase Manhattan Bank, R-I(a)-522; Kenneth Larkin, Bank of America, Tr. 5673; Robert Bark, Republic National Bank of Dallas, R-I(A)-872. *Finance Companies:* Hyman Wehner, Atlantic Finance Co., California Loan and Finance Association, Tr. 6494. James Ambrose, International Consumer Credit Association, R-I(a)-432; Robert E. Dean, Security Mutual Finance, Alabama Consumer Finance Association, Tr. 155; William Lehye, Consumer Loan Co., Tr. 4365; H. E. Smith, Alabama Lenders Association, R-I(a)-383; Fred Harvey, Georgia

In and of itself, standardization is not an indictment of the consumer loan market. The use of standardized forms is an efficient, low cost method of conducting a loan transaction.[5] The costs of negotiating with each customer would surely outweigh the benefits that would result from individually tailored contracts. As the Presiding Officer found, "it is simply not feasible to conduct the transaction any other way."[6] In addition, testimony indicates that the complex regulatory environment in which most lenders do business makes precise

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Industrial Loan Association, Tr. 4476; Stephen Hellerstein, Colorado Industrial Bankers Association, Colorado Consumer Finance Association, Tr. 7113; Joseph Park, Community Finance Co., Tr. 3210; Frank J. Fore, Ford Motor Credit Co., R-I(a)-816. *Retailers:* Gordon Wear, Texas Independent Automobile Dealers, Tr. 707; Robert Lewis, Firestone Tire & Rubber Co., R-I(a)-669; F. T. Weimer, Sears, Roebuck and Co., R-I(A)-427. *Credit Unions:* James Barr, National Association of Federal Credit Unions, R-I(a)-464; Harold Welsh, Illinois Credit Union League, Tr. 4091; Jackson Guyton, Mutual Savings Credit Union, R-I(a)-342. *Legal Aid Attorneys:* James Hiatt, Legal Aid of Oklahoma, R-I(c)-14; John Paer, Legal Aid of Hawaii, Tr. 5339; Jonathan Epstein, Essex/Neward Legal Services, Tr. 8943; Eric Wright, Professor of Law, University of Santa Clara, Tr. 8059; Alex Soldamando, District Attorney, San Francisco, R-I(d)-220; Jane Johnson, New Orleans Legal Assistance, Tr. 405; John Seveck, California Legal Assistance, Tr. 6994; Pamela Plerring, C.A.M.P., Consumer Action Project, Tr. 6375; Charles Pyle, Southern Legal Aid, Inc., Tr. 479; Richard Halliburton, Legal Aid and Defender Society of Kansas City, Tr. 114; David Driscoll, El Paso Legal Assistance, Tr. 1614. *Others:* Gerald Kell, Board of Governors, Federal Reserve System, HX-450; Michael Hayes, Center of Law and Social Policy, R-I(c)-32; Vern Countryman, Professor of Law, Harvard University School of Law, Tr. 9143; Raphael L. Podolsky, Connecticut Legal Assistance, Tr. 10818; Thomas Raleigh, (self) Illinois Consumer Protection, Tr. 2454; William S. Ballenger, Michigan Department of Licensing and Regulation, Tr. 8176.

[5] *E.g.*, David Pohl, Capital Financial Services, R-I(a)-541; Sam Kelly, Consumer Credit Administrator, State of Texas, Tr. 1294; Harold Welsh, Illinois Credit Union League, Tr. 4091; Jackson Guyton, Mutual Savings Credit Union, R-I(a)-342, Charles Towers, Florida Consumer Finance Association, Tr. 3802; William Lehye, Consumer Loan Co., Tr. 4365; H. E. Smith, Alabama Lenders Association, R-I(a)-383; Kenneth Lakin, Bank of America, Tr. 5673.

[6] Presiding Officer's Report at 61.

contract wording important, and thereby necessitates the use of standardized contracts.[7]

In a well-functioning market, competition among sellers would tend to produce the mix of standardized contract terms that would best satisfy borrower preferences.[8] Despite the use of standardized contracts, individual creditors have incentives to compete with each other by offering different standard form contracts, provided that a sufficient number of consumers know about the differences and prefer one contract to another.[9] In such circumstances, consumers could reasonably avoid undesirable contracts, and there would be no basis for Commission intervention. It is therefore necessary to examine the factors that limit consumer search for more desirable credit contracts.

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[7] In some cases, lawyers and courts have struggled for years refining the language of these contracts. See Robert E. Dean, Alabama Consumer Finance Assoc., Tr. 157; Mark A. Denny, Nebraska Consumer Credit Assoc., Tr. 3747; Charles W. Lowers, Florida Consumer Finance Assoc., Tr. 3802.

In some states a form cannot be altered without approval from the regulatory authority. Amoung the states that require prior review and approval are Wisconsin, Richard A. Victor, Assistant Attorney General, R-I(d)-42 at 3; Alabama, Robert E. Dean, Alabama Consumer Finance Assoc., Tr. 155-56; Nevada, Frank J. Fahrenkopf, Jr., Nevada Consumer Finance Association, Tr. 7857; Florida, Charles W. Lowers, Florida Consumer Finance Assoc., Tr. 3802; Rhode Island, John J. Dunnigan, Lincoln Finance, Tr. 10215-16; and California, William Probasco, Mid-Valley Time Loan, Tr. 6118. In Idaho, creditor forms are reviewed annually. Tom D. McEldowney, Director, Idaho Department of Finance, Tr. 5077.

[8] *E.g.*, John Umbeck, Purdue University, Tr. 9557; *cf.*, William Ballenger, Director, Michigan Department of Licensing and Regulation, Tr. 8176.

[9] This general proposition is widely recognized in the economic literature. *See, e.g.*, Schwartz and Wilde, *Intervening in Markets of the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U.Pa.L.Rev. 630 (1979); Beales, Craswell, and Salop, *The Efficient Regulation of Consumer Information*, 24 Journal of Law and Economics 491 (1981). Its applicability to consumer credit markets was recognized by the National Commission on Consumer Finance (NCCF) in the context of Truth in Lending disclosures. *See Consumer Credit in the United States*, Report of the NCCF at 176-7 (1972).

execution or garnishment although they dispute the underlying claim.[75] Legal aid attorneys estimate that actual (or threatened) invocation of cognovits results in payment of disputed debts in a significant number of cases.[76]

Even when debtors understand their right to challenge the entry of judgment, post-judgment remedies of the sort provided by Pennsylvania statute do not make them whole. The procedure for reopening a judgment is complex and debtors are unlikely to succeed without incurring the cost of hiring an attorney.[77] In addition to legal fees, sheriff's costs and deposition and transcript costs are ordinarily required in a proceeding to strike or reopen.[78] Such costs are not necessarily incurred in a trial de novo.

In a proceeding to reopen, the debtor may assert the same affirmative defenses that could have been used in defending against an action on the underlying claim. However, in a proceeding to reopen the burden and expense of instituting litigation shift from the creditor, where they would lie absent the confession of judgment, to the debtor.[79] Because of the relative ease with which confessions of judgment may be

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[75] Henry J. Sommer, Community Legal Services of Philadelphia, Tr. 10980.

[76] Confessions of judgment are more commonly used in unsecured loans, *see* Robert P. Shay, National Consumer Finance Association, HX-494 at 34, where consumer defenses may be less likely. Nonetheless, 22 consumer law specialists estimated that payment of disputed debts occurred in 23 percent of cases, based on their experiences in serving mainly low-income consumers. NCLC survey, *supra* note 54, HX-467 at 44-45.

[77] *See* discussion of Pennsylvania procedures for reopening *supra* notes 38-42 and accompanying text. Because the procedure for reopening depends essentially on depositions, *see Swarb v. Lennox*, 314 F. Supp. 1091, 1095 (E.D. Pa. 1970), *aff'd*, 405 U.S. 191 (1972), it would be extremely difficult for a judgment debtor to proceed effectively *pro se*. *See, e.g.*, Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3372.

[78] *Swarb v. Lennox*, 314 F. Supp. 1091, 1095 (E.D. Pa. 1970), *aff'd*, 405 U.S. 191 (1972).

[79] *Id.* at 314 F. Supp. 1095; Bernard A. Podcasy, Legal Services of Northeastern Pennsylvania, Tr. 9629.

entered, creditors may be tempted to use them indiscriminately.[80] To the extent that consumers must institute legal action to defend against unwarranted claims, they suffer considerable economic injury through the costs that they must incur.

Although consumers with meritorious defenses may ultimately succeed in vacating judgments against them, they are deprived of the full use of their property during the process. Under Pennsylvania law the entry of judgment creates a lien on the consumer's property and thus encumbers the right to use it.[81] Until such a lien is dissolved, the consumer's ability to use the property for collateral or to dispose of it is significantly impaired.[82] Moreover, because the lien is effective whether or not notice is mailed to or reaches the debtor,[83] debtors may learn of its existence only at the precise point at which they seek to use the property for such purposes.[84] By the time debtors succeed in dissolving the lien, the opportunity for which they intended to use the property may have passed. Consumers have no recourse for the economic injury that is suffered as a result. There is no statutory provision for an award of damages to a consumer **[7754]** whose property has been improperly encumbered.

The record demonstrates that economic loss of several different sorts is experienced by debtors against whom confessions of judgment are entered. Injury occurs even when

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[80] *See* NCLC survey, *supra* note 54, HX-467 at 44 (72 percent median success rate in reopening cognovit judgments suggests invalid use of confessions by creditors); *see also* discussion of potential for abuse of cognovit provisions *supra* note 72.

[81] Pa. Ct. R. Civ. P. 236 (West 1983).

[82] *See, e.g., Nesbitt* v. *Blazer Financial Services*, 550 F. Supp. 819, 830 n.8 (N.D. Ill. 1982).

[83] Pa. Ct. R. Civ. P. 236 (West 1983).

[84] When a judgment is executed upon years after its entry, judgment debtors suffer significant practical problems in producing evidence of any defenses they may have. *See, e.g.*, Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11106; Herschel T. Elkins, Office of the Attorney General of California, Tr. 5290-91.

consumers ultimately succeed in overturning a confessed judgment.[85] Accordingly, we find that the use of cognovits causes substantial consumer injury.

E. Offsetting Benefits

Conflicting evidence appears in the rulemaking record with respect to the benefits derived from the use of cognovits. There is testimony indicating that confessions of judgment are considered a particularly useful collection device in Pennsylvania[86] and Illinois.[87] Other evidence suggests that some creditors do not consider them to be of great utility, however.[88]

Those who supported the importance of cognovit clauses suggested that the abolition of confessions of judgment might decrease credit supply or increase credit cost.[89] One commenter suggested that large finance companies and commercial banks might require security for loans more frequently than they currently do if cognovits were abolished. [90]

In contrast, the National Commission on Consumer Finance found that where states had prohibited or restricted

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[85] In the NCLC survey legal aid attorneys estimate that the likelihood of success in reopening a confessed judgment is 72 percent. *See* discussion *supra* note 80. A Pennsylvania legal aid attorney estimates that she succeeded in reopening close to 50 of 100 confessed judgments in three years. Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11122.

[86] Burton Caine, Professor of Law, Temple University, on behalf of the Pennsylvania Consumer Finance Association, Tr. 8423.

[87] Clarence Naborowski, Illinois Consumer Finance Association, Tr. 3845-46.

[88] The NCCF survey shows that only 17 percent of large banks and finance companies rate cognovits as among the two most essential provisions in unsecured loan contracts. *See supra* note 63 and accompanying text.

[89] *See, e.g.*, Herschel C. Adcock, Louisiana Consumer Finance Association, Tr. 1211-13; rebuttal submission of the National Consumer Finance Association, R-XIII-31 at 50; Richard Peterson, Credit Research Center, Purdue University, Tr. 9466; Robert P. Shay, National Consumer Finance Association, HX-494 at 34, Tr. 12054; Clarence Naborowski, Illinois Consumer Finance Association, Tr. 3846; Richard K. Slater, Consumer Bankers Association, Tr. 11630.

[90] Robert P. Shay, National Consumer Finance Association, HX-494 at 34.

confessions of judgment, there had been, in fact, no significant effect on the cost or availability of consumer credit.[91] Other commenters agreed with this finding with respect to the extension of credit in their states.[92]

The principal reason that the abolition of cognovits might increase the cost of credit is that creditors would be required to file suit against defaulting debtors rather than merely filing a confession and obtaining judgment. Suit was described as a more time-consuming and costly procedure by one commenter from Illinois.[93] Another stated, however, that although instituting suit might impose a thirty or forty day delay in carrying out collection activities, the abolition of confessions of judgment would have no practical significance for creditors.[94]

In fact, it appears that as many as 91 percent of debtors fail to appear to defend when creditors institute suit against them.[95] To the extent that debtors do not answer and defend,

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[91] This conclusion was based on a cross-state econometric model of survey data obtained from four different types of lending institutions. *See Consumer Credit in the United States*, Report of the NCCF, 26 (1972), R-XI-11(g). Richard Peterson, Credit Research Center, Purdue University, Tr. 9466, criticizes the NCCF survey results. For a critical analysis of Mr. Peterson's methodology, *see* Staff Report at 110, n.70.

[92] *E.g.*, James G. Boyle, Texas Consumer Association, Tr. 21-22; Thomas Tahnk, Minnesota Office of Consumer Services, Tr. 2902-03; Patrick Ryan, Oklahoma Department of Consumer Affairs, Tr. 764-65; James Davis, Indiana Department of Financial Institutions, Tr. 4764.

[93] Clarence Naborowski, Illinois Consumer Finance Association, Tr. 3846.

[94] Michael Brown, United Auto Dealers Association, Chicago, Tr. 3846.

[95] David Caplovitz, *Consumers in Trouble: A Study of Debtors in Default* 222 (1974). *See also* Clarence Naborowski, Illinois Consumer Finance Association, Tr. 3845; James H. Hiatt, Legal Aid Society of Oklahoma County, R-I(c)-14 at 2.

As discussed more fully *supra* at notes 6-14, it is the opportunity to exercise due process rights before deprivation of property occurs that is constitutionally mandated. Whether to exercise this opportunity is a matter of individual choice, in which many factors—including lack of a defense—may be involved.

creditors do not incur the legal expenses of preparing for and litigating their claims. Thus, although creditors may experience a slight delay in collection activities, it is unlikely that any significant additional costs will be incurred in the vast majority of cases.

Other testimony suggested that creditors might respond to the abolition of confessions by increasing the use of other more costly remedies that remain available, [96] so that additional costs would transfer to the debtor. On the other hand, commenters note that the use of cognovits imposes additional costs upon debtors who seek to reopen judgments against them,[97] and may force debtors in marginal financial circumstances into bankruptcy.[98] Thus, the costs associated with the prohibition of cognovits appear to balance the costs inherent in their use.

Without cognovits, creditors will be required to litigate their claims against those consumers who choose to appear and defend. In these cases creditors may ultimately incur greater expense than they would have through the simple entry of judgment. Presumably, at least some of these same consumers would have petitioned for reopening of the judgment, however. In such cases, the creditor would have incurred the expense of litigation in any event. Thus, except to the extent that debtors who would not otherwise have done so are encouraged to contest creditors' claims when served

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[96] For example, it was suggested that if cognovits were abolished, lenders might make more frequent use of mortgages to secure consumer loans. Costs of preparing and filing mortgages are said to be higher than costs of preparing and filing confessions of judgment. *See, e.g.*, Ernest T. Salzer, Bank of Pennsylvania, Reading, Post-Record Comments XV-51 at 1-2; C.R. Gearhart, Pittsburgh National Bank, Post-Record Comments XV-238 at 2.

[97] Richard Alpert, National Consumer Law Center, R-I(d)-85 at 15; Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11103; *see also* Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3371-72.

[98] W.C. Evans, Texas Finance Association, Tr. 974. *But see* Robert P. Shay, National Consumer Finance Association, HX-494 at 35.

with a complaint as opposed to notice of judgment, this provision of the rule will have little economic impact on creditors.[99]

Viewed as a whole, the record demonstrates that confessions of judgment do not produce significant benefits to creditors or, by extension, to consumers. Because the injury associated with their use can be substantial, the Commission finds that any benefits produced by their continued use do not outweigh the injury that they cause to consumers.

F. Alternatives Considered and Modifications Adopted

This rule provision is intended merely to ensure that, before any deprivation of property occurs, debtors will be afforded the basic due process rights of notice and an opportunity to be heard. The proposed rule addressing confessions of judgment originally prohibited the taking or receiving from a consumer an obligation constituting, *inter alia*, a "power of attorney." In response to the concerns expressed by many commenters, the phrase "warrant of attorney" has been substituted instead in the final version of the rule. This revision is designed to ensure that real estate first mortgages and deeds of trust are not affected by this rule [7755] provision. Such agreements typically contain powers of attorney for purposes of foreclosure, subject to various state restrictions governing, for example, mortgagors' rights to cure, equitable rights of redemption, and permissible notice and sale procedures. This rule provision is intended to bar the use of confessions of judgment in real estate-secured second mortgage loan obligations, however, to the extent that the proceeds of such secured loans are used for consumer purchases.[100]

Similarly, powers of attorney given to expedite the transfer of pledged securities of the disposal of repossessed chattels

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[99] The NCLC survey of legal aid attorneys, *supra* note 54, HX-467 at 44-45, suggests that the use of cognovits results in the payment of disputed debts in 23 percent of their cases. The record provides no basis for estimating what percentage of these debtors would defend against a complaint where they would not have sought to reopen a judgment.

[100] *See* rule definitions, § 444.1 (a), (b), and (d).

are not within the scope of this provision. For example, an automobile installment sale contract may include a power of attorney authorizing transfer of title in the event of repossession and sale of the vehicle. A power of attorney for this purpose would not constitute a "waiver of the right to notice and the opportunity to be heard in the event of suit or process" as contemplated by § 444.2(a)(1). This applies as well to a power of attorney to transfer ownership of pledged stocks, bonds, or similar instruments.

A power of attorney in an insurance premium finance contract enables prompt cancellation of an underlying third-party insurance agreement in the event of default.[101] Such provisions likewise do not fall within the ambit of the rule because they do not entail loss of notice and hearing rights "in the event of suit or process." Comparable powers of attorney in two-party insurance agreements will be unaffected as well.[102]

This section of the rule was also revised, in response to testimony and written comments, so as not to apply to the Louisiana Via Executiva process. The state of Louisiana prohibits confessions of judgment except for purposes of executory process.[103] This civil law executory procedure enables a creditor, when making a loan, to take a mortgage on property that is specifically identified in the mortgage. The mortgage may contain a confession of judgment, which has the effect of creating a security interest in the specified property.[104] Thus, the Louisiana confession of judgment operates in rem; it is used only to execute upon property that the debtor has selected to serve as collateral. Unlike confessions of judgment in common law jurisdictions, it does not operate in personam

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[101] J. Robert Sweat, Florida Premium Finance Association, Tr. 9753; *see also* Robert C. Duke, Texas Consumer Finance Association, Tr. 1813-14.

[102] *See Jeffrey Yates, National Association of Insurance Agents, R-I(a)-581.*

[103] La. Rev. Stat. Ann. § 9:3590 (West 1983).

[104] Herschel C. Adcock, Louisiana Consumer Finance Association, Tr. 1215-16, 1224.

and, therefore, it does not create a general lien on other property of the debtor.[105] In sum, the property that may be encumbered or sold under Louisiana's executory process appears to be consciously chosen wit.. that possibility in mind by the debtor. To the extent that Louisiana executory process may involve the loss of any due process rights, the Commission lacks sufficient evidence to find that these rights are waived involuntarily or unknowingly.

Finally, confessions of judgment prohibited by this rule provision should be distinguished from the cognovit actionem, or confession acknowledging liability following institution of suit and service of process. Unlike the latter, which is executed in conjunction with negotiated settlements, the prohibited confessions of judgment involve anticipatory waivers of procedural due process protections in the context of credit obligations.[106]

V. Wage Assignments

Section 444.2(a)(3) of the rule provides that it is an unfair act or practice for a lender or retail installment seller to take or receive from a consumer an obligation that constitutes or contains a clause that makes an assignment of wages unless the assignment by its terms is revocable at the will of the debtor, constitutes a payroll deduction or preauthorized payment plan, or is an assignment of wages already earned.

A. Nature of the Practice

A wage assignment is a contractual transfer by a debtor to a creditor of the right to receive wages directly from the

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[105] *Id.* at Tr. 1215.

[106] Numerous comments on the record urged that confessions of judgment obtained in the settlement or disposition of a pending action should not be prohibited, as they are entered into after the debtor has had notice and an opportunity to be heard. *See, e.g.*, George H. Braasch, American Bar Association Committee on Consumer Credit, R-I(d)-76; F.T. Weimer, Sears, Roebuck and Co., R-1(a)-427. Due process implications of the cognovit actionem are discussed more fully *supra* at notes 22-23 and accompanying text.

debtor's employer. To activate the assignment, the creditor simply submits it to the debtor's employer, who then pays all or a percentage of debtor's wages to the creditor.[1] The debtor releases the employer from any liability arising out of the employer's compliance with the wage assignment, and may waive any requirement that the creditor first establish or allege a default.[2] Absent a statutory restriction, it is not necessary to obtain the employer's consent to enter into a wage assignment.[3]

Wage assignment and wage garnishment are both methods by which a creditor can obtain the debtor's wages to apply to or satisfy a debt. Procedurally, however, the two remedies are very different. Garnishment requires that the creditor obtain a court judgment before wages can be garnished to collect the debt. The Supreme Court has held that prejudgment garnishment deprives the debtor of constitutional due process rights.[4] Wage assignment, on the other hand, does not require

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[1] Presiding Officer's Report at 115. For an example of a typical wage assignment, *see* Gwyneth D. Gillingham, Legal Aid Society of Kent County, R-I(c)-69 at Exh. B.

[2] Some state statutes prohibit the creditor from filing a wage assignment with an employer unless there is a payment in default. *See e.g.*, Ill. Ann. Stat. ch. 48, section 39.2 (Smith-Hurd 1976).

[3] 6 Am. Jur. 2d Assignments section 46 (1963).

[4] *Sniadach* v. *Family Finance Corp.*, 395 U.S. 337 (1969). The Wisconsin garnishment statute at issue in *Sniadach* required that the debtor receive a summons and complaint within 10 days after service of garnishment on the employer. Wages were frozen, however, during those 10 days. 395 U.S. at 338-39. The court found that:

> [The wages] may, it is true, be unfrozen if the trial of the main suit is ever had and the wage earner wins on the merits. But in the interim the wage earner is deprived of his enjoyment of earned wage without any opportunity to be heard and to tender any defense he may have, whether it be fraud or otherwise.
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> 395 U.S. at 339.

It is the seizure of wages before notice and hearing that violates due process. Justice Harlan wrote in his concurrence in *Sniadach* that "due process is afforded only by the kinds of 'notice' and 'hearing' which are aimed at establishing the validity, or at least the probable validity, or the

a judgment. A creditor can file a wage assignment without any judicial review of the creditor's claim. The debtor does not have a hearing with an opportunity to assert any defenses. Unlike prejudgment garnishment, prejudgment wage assignment has usually survived constitutional challenge.[5] There is no meaningful distinction between the effects of the two remedies,[6] but when [7756] presented with challenges to wage assignments, courts generally have not found sufficient state action[7] in the assignment to trigger the due process protections of the fourteenth amendment; thus courts have not reached the merits of challenges based on constitutional claims.[8]

Some wage assignments are used as a method of making regular payments on a debt prior to delinquency rather than

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underlying claim against the alleged debtor *before* he can be deprived of his property or its unrestricted use." 395 U.S. at 343 (Harlan J. concurring) (emphasis in original).

Additionally, the court considered the nature of the seized property and, in a passage that applies with equal force to wage assignments, wrote:

> We deal here with wages—a specialized type of property presenting distinct problems in our economic system * * * . A prejudgment garnishment . . . is a taking which may impose tremendous hardship on wage earners with families to support.

395 U.S. at 340.

[5] *But see, e.g., Foster's Application*, 23 Pa. D. 558 (1914), *aff'd*, 60 Pa. Super. 8 (1915) (Pennsylvania wage assignment statute held to violate state constitution).

[6] The Presiding Officer referred to wage assignment as the "contractual equivalent of garnishment * * * ." Presiding Officer's Report at 124.

[7] The due process clause of the fourteenth amendment applies only to state action, not to private conduct. U.S. Const. amend. XIV, section 1 ("nor shall any *State* deprive any person of life, liberty, or property, without due process of law * * *) (emphasis added).

[8] *See e.g., Bond* v. *Dentzer*, 494 F.2d 302 (2d Cir.), *cert. denied*, 419 U.S. 837 (1974); *Donahoo* v. *Household Finance Corp* 472 F. Supp. 353 (E.D. Mich. 1979).

as a collection remedy.[9] These wage assignments are essentially voluntary payroll deductions, and are used most frequently by credit unions and other creditors closely associated with the employer.[10] This record does not indicate that payroll deduction wage assignments cause consumer injury;[11] we have therefore exempted such assignments from the rule. Similarly, preauthorized electronic fund transfers to accounts from wages may be considered to be wage assignments,[12] but they are used as methods of payment rather than as a collection remedy.[13] Thus, they are exempted from the rule because this rulemaking record does not show that they cause consumer injury.[14]

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[9] Presiding Officer's Report at 121-22.

[10] For examples of payroll deduction payment plans, *see, e.g.*, Merle Jewell, Boeing Employees' Credit Union, Tr. 10905-12; Tilman R. Thomas, Jr., Government Employees Credit Union, Tr. 838-40; David White, National Association of Federal Credit Unions, HX-459 at 5; Burton Caine, Pennsylvania Consumer Finance Association, Tr. 8429.

[11] Presiding Officer's Report at 129, 131. *See also* discussion *infra*, Sections D and F.

[12] Presiding Officer's Report at 129, *citing* William T. Gwennap, American Bankers Association, HX-500 at 5.

[13] Electronic transfers are governed by the Electronic Fund Transfers Act, 15 U.S.C. Part 1693 *et seq.* (1982) and the implementing regulations at 12 CFR Part 205 (1983). A preauthorized transfer may be revoked by the consumer with a three-day notice. 15 U.S.C. 1693e (1982); 12 CFR Part 205.10(c) (1983).

[14] *See* discussion of consumer injury *infra* Section D.

B. State Law

Wage assignments are prohibited in the Uniform Consumer Credit Code States,[15] several other states,[16] and in the District of Columbia.[17] A substantial majority of the remaining states have imposed restrictions on the use of wage assignments. Some of the more common restrictions are: a time limit for

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[15] Colo. Rev. Stat. Ann. sections 5-2-410, 5-3-403 (1973); Idaho Code section 28-43-304 (Supp. 1983); Ind. Code Ann. sections 24-4.5-2-410, 24-4.5-3-403 (Burns 1982); Iowa Code Ann. section 537.3305 (West Supp. 1983-84); Kan. Stat. Ann. section 16a-3-305 (1981); Me. Rev. Stat. Ann. tit. 9A, section 3-305 (1980); Okla. Stat. Ann. tit. 14A, sections 2-410, 3-403 (1983); Utah Code Ann. sections 70B-2-410, 70B-3-403, (1980); Wyo. Stat. Ann. sections 40-14-244, 40-14-334 (1977).

All of the U.C.C.C. states except Colorado permit an employee to authorize deductions from his or her wages as long as the authorization is revocable. Idaho and Iowa also require that the debtor receive a complete copy of the document evidencing the authorization, and that the document contain a conspicuous notice of the right to revoke.

In addition, South Carolina and Wisconsin have enacted consumer protection codes that are substantially similar to the U.C.C.C. and incorporate the U.C.C.C. wage assignment prohibition. *See* S.C. Code Ann. sections 37-2-410, 37-3-403 (Law. Coop. 1976), Wis. Stat. Ann. section 422.404 (West 1974).

[16] Ala. Code section 8-5-21(a) (1975) (assignment of future wages void); Conn. Gen. Stat. Ann. section 52-361(g) (Supp. 1983-84); Ohio Rev. Code Ann. section 1321.32 (Page 1979), (assignment valid only if for child support), section 4113.16 (Page 1980).

In Pennsylvania, a statute regulating the assignment of future wages was held to be unconstitutional in *Foster's Application*, 23 Pa. D. 558 (1914), *aff'd*, 60 Pa. Super. 8 (1915).

[17] D.C. Code Ann. section 28-2305(a) (1981).

the assignment,[18] a requirement that the employer[19] or spouse[20] consent to the assignment, and an absolute prohibition of assignment in certain kinds of transactions.[21] In addition, some states require that the wage assignment be on a

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[18] *See e.g.*, Ariz. Rev. Stat. Ann. section 6-631 (Supp. 1982) (four years); Ill. Ann. Stat. ch. 48, sections 39.3, 39.5 (Smith-Hurd 1976) (two years as to future employers; three years otherwise); Ky. Rev. Stat. Ann. section 371.140 (Bobbs-Merrill 1971) (ninety days, small loans); Md. Com. Law Code Ann. section 15-302 (1975) (six months); Mass. Gen. Laws Ann. ch. 154, section 2 (West Supp. 1983-84) (one year, small loans); Mass. Gen. Laws Ann. ch. 154, section 3 (1971) (two years, loans above $3,000); Minn. Stat. Ann. section 181.06 (West Supp. 1983) (sixty days unless salary is over $1,500 per month, then 5 years); R.I. Gen. laws section 28-15-2 (1979) (one year); W. Va. Code section 21-5-3 (1981) (one year).

[19] *See e.g.*, Ark. Stat. Ann. section 81-316 (1976); Del. Code Ann. tit. 5 section 2115 (1974); La. Rev. Stat. Ann. section 23.731 (West Supp. 1983); Mass. Gen. Laws Ann. ch. 154, section 2 (West Supp. 1983-84); Minn. Stat. Ann. section 181.05 (West 1971); Miss. Code Ann. section 71-1-45 (1972); N.C. Gen. Stat. section 95-31 (1981); Tenn. Code Ann. section 50-2-105(a) (1983); W. Va. Code section 21-5-3 (1981).

[20] *See e.g.*, Ariz. Rev. Stat. Ann. section 6-631 (Supp. 1982); Ark. Stat. Ann. section 81-317 (1976); Cal. Lab. Code section 300 (Deering Supp. 1983); Hawaii Rev. Stat. section 409-20 (1976); Md. Com. Law Code Ann. section 12-311 (Supp. 1981); Mass. Gen. Laws Ann. ch. 154, section 2 (West Supp. 1983-84); Minn. Stat. Ann. section 181.07 (West Supp. 1983); Neb. Rev. Stat. section 45-144 (1978); R.I. Gen. Laws section 19-25-33 (1968); Vt. Stat. Ann. tit. 8, section 2228 (1970); Va. Code Ann. section 6.1-289 (1983).

[21] *E.g.*, wage assignments prohibited in small loans; Fla. Stat. Ann. section 516.17 (West Supp. 1983); Md. Com. Law Code Ann. section 12-311(a)(2) (1983); Mich. Comp. Laws Ann. section 493.17 (West Supp. 1983-84); Nev. Rev. Stat. section 675.340 (1979); N.J. Stat. Ann. section 17:10-17 (West Supp. 1983-84); N.C. Gen. Stat. section 53-180(b) (1982); N.D. Cent. Code section 13-03-17 (1981); Or. Rev. Stat. section 725.355 (1981); Tex. Rev. Civ. Stat. Ann. art. 5069-3.20(i), 5069-4.04(1) (Vernon 1971). Wage assignments prohibited in retail installment contracts: Hawaii Rev. Stat. section 476-13 (1976); Md. Com. Law Code Ann. section 12-607(7) (1983); Mass. Gen. Laws Ann. ch. 255D, section 10(8) (West Supp. 1983-84); Mich. Comp. Laws Ann. section 445.864(1)(b) (West Supp. 1983-84); Minn. Stat. Ann. section 325G.16(2)(c) (West 1981); N.J. Stat. Ann. section 17:16C-39 (West Supp. 1983-84); N.M. Stat. Ann. section 56-1-5.B (1978); N.D. Cent. Code section 51-13-02.1(2) (1982); Or. Rev. Stat. section 83.150(2) (1981); Tex. Rev. Civ. Stat. Ann. art. 5069-6.05(2) (Vernon 1971); Vt. Stat. Ann. tit. 9, section 2456 (1970). Wage assignments

separate document,[22] and some allow the debtor to contest a wage assignment by informing the employer that he or she has a defense.[23]

Some states have enacted a limitation (generally 15 percent to 25 percent) on the amount of weekly or monthly wages that may be assigned.[24] State provisions are inconsistent, however, and do not always offer adequate protection.[25] [7757]

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prohibited in home repair loans: Me. Rev. Stat. Ann. tit. 9, section 3724(6) (1980); N.J. Stat. Ann. section 17:16C-64 (West 1970). Wage assignments prohibited in motor vehicle sales: Mass. Gen. Laws Ann. ch. 255B, section 20(1) (West Supp. 1983-84); N.H. Rev. Stat. Ann. section 361-A:7 VIII(1) (1966); Or. Rev. Stat. section 83.670(1) (1981); Tex. Rev. Civ. Stat. Ann. art. 5069-7.07(2) (Vernon 1971); N.Y. Pers. Prop. Law section 302(13)(b) (McKinney 1976).

[22] *See, e.g.*, Cal. Lab. Code section 300(b)(1) (Deering Supp. 1983); Ill. Rev. Stat. ch. 48, section 39.1(5) (Smith-Hurd 1969); N.Y. Pers. Prop. Law section 46-C(a) (McKinney 1976).

[23] *See, e.g.*, Ill. Ann. Stat. ch. 48, section 39.4a (Smith-Hurd Supp. 1983-84); N.Y. Pers. Prop. Law sections 46-e-48 (McKinney 1976).

[24] *See, e.g.*, Ill. Ann. Stat. ch. 46, section 39.4 (Smith-Hurd Supp. 1983-84) (15 percent); Mass. Gen. Laws Ann. ch. 154, section 3 (1971) (25 percent); N.M. Stat. Ann. section 58-15-22.B (1978) (10 percent); N.Y. Pers. Prop. Law section 48-a (McKinney 1976) (10% for loans less than $1,090); W. Va. Code section 46A-2-116 (1980) (25 percent). *See also* Neb. Rev. Stat. section 36-213 (1978) and Va. Code Ann. section 34-29(e) (Supp. 1983) (same limit as for wage garnishment).

[25] Not all states limit the amount of pay that can be taken with a wage assignment, *e.g.*, Ark. Stat. Ann. sections 81-316, 81-317 (1976); Miss. Code Ann. section 71-1-74 (1972); Wash. Rev. Code sections 49.48.090, 49.48.100 (1962) (statutory provisions governing wage assignments do not include any limit on the amount that can be assigned). *See also* Commerce Clearing House Consumer Guide at ¶ 650.

Even in states with limits, creditors have sometimes taken more than the state limit and more than the 25 percent permitted under the federal Consumer Credit Protection Act, 15 U.S.C. 1671-1677 (1982). *See* Robert Atkinson, Legal Aid Service of Portland, Tr. 5930-31 (credit unions take entire paycheck when debtors' employment terminates); Daniel Hedges, Esq., Tr. 11361 (company stores take 70-80 percent of consumers' wages despite West Virginia statute limiting wage assignments to 25 percent of the debtors' earnings). *See also Western* v. *Hodgson*, 494 F.2d 379, 380 (4th Cir. 1974) (because of a wage assignment, consumers received "no take-

Federal statutory limitations on wage garnishment[26] do not apply to wage assignments.[27] Thus, unless there is a state statutory limitation, creditors are restricted only by the terms of the wage assignment.

C. Prevalence

The rulemaking record[28] shows that wage assignments are used primarily by small loan and finance companies, and

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home wages for some pay periods and less than 75% of their wages for other pay periods"); Thomas D. Crandall, Esq., Tr. 10666 (former client lost 80 percent of his wages because of wage assignment); Presiding Officer's Report at 127.

[26] The Consumer Credit Protection Act, 15 U.S.C. 1671-1677 (1982) limits the amount of wages that can be garnished and prohibits an employer from discharging an employee if wages are garnished for any one indebtedness.

[27] *See, e.g., Western* v. *Hodgson*, 494 F.2d 379 (4th Cir. 1974) (wage assignments are exempt from the Consumer Credit Protection Act).

[28] The evidence of record includes the following surveys:

1. A 1977 National Consumer Finance Association (NCFA) survey of accounts from a sample of national finance companies, *see* HX-495, HX-496, HX-497.

A state-by-state breakdown of the survey results revealed significant numbers of wage assignments in four states. R-XIII-36:

	Small loans (percent)	Sales finance (percent)
California	32	—
Illinois	86	58
Michigan	66	36
New York	68	53

California permits only the assignment of wages already earned, so that statistics for California are not comparable to figures for other states.

2. A 1972 National Commission on Consumer Finance (NCCF) survey, *see* NCCF Technical Studies, Vol. V at 64-66 (1972).

The NCCF reported results on a national basis without providing a state by state breakdown. In addition, in the personal loan area, firms were directed to answer "yes" to the relevant question only if they included wage assignments in "substantially all of your personal loans." *Id.* at 217.

[footnote continued]

most heavily in California, Illinois, Michigan,[29] and New York.[30] The National Consumer Finance Association (NCFA) reported that wage assignments were included in approximately 13 percent of the small loan contracts surveyed[31] and in approximately 6 percent of purchased sales finance contracts held by surveyed companies.[32] Some record evidence suggests, however, that the percentage of contracts with wage

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The results of the NCCF survey were as follows:

Finance companies . . .	13 percent (personal loans). 1-2 percent (indirect paper).
Banks	3-4 percent (depending on nature of the transaction and size of bank.)
Retailers	3 percent (revolving credit). 1 percent (installment credit).

Id., at 64-68.

3. A 1977 Consumer Bankers Association (CBA) survey of member banks, *see* HX-490, HX-491.

Members of the CBA are, in general, larger banks that do a high volume of consumer lending business. Richard Slater, Consumer Bankers Association, Tr. 11635-36. The CBA requested responses only from banks in states that permit wage assignments. HX-491, question 14. The CBA survey found that 26 percent of banks responding indicate use of wage assignments in the majority of personal loan contracts, compared to 7 percent for both automobile direct loans and automobile indirect paper. HX-490, Table 8.

[29] Since the development of the rulemaking record, Michigan has statutorily prohibited small loan company wage assignments. Mich. Comp. Laws Ann. section 493.17 (West Supp. 1983-84). The statute became effective on March 31, 1981.

[30] The rulemaking record shows that wage assignments have also been used in, among other states, New Jersey, Florida, and Virginia. XI-153 at 35-49. The record also indicates that wage assignments are used, albeit to a lesser extent, by creditors other than small loan and finance companies. Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3380 (retailers sometimes use wage assignments); Daniel Hedges, Appalachian Research and Defense Fund, Tr. 11358 (company stores use wage assignments).

[31] NCFA survey, *supra* note 28 at HX-496, HX-497.

[32] *Id.* at HX-496.

assignments may be significantly higher than the NCFA survey shows. For example, the Secretary of the New York State Consumer Finance Association testified that in 1975, wage assignments were included in 73.2 percent of loans made by licensed New York lenders.[33]

Wage assignments may be obtained from co-signers[34] and spouses[35] as well as from the principal debtor, and are commonly used with other forms of security.[36] In states that permit wage assignments, consumers cannot reasonably shop around for a contract [LINE OMITTED IN ORIGINAL] of wage assignments are actually filed with employers.[38]

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[33] Alfred Orlin, Tr. 11400, *citing* New York State Banking Department statistics.

[34] *See, e.g.*, finance company consumer files R-XI-LIB 340; R-XI-LIB 338; R-XI-LIB 368; R-XI-BEN 13; testimony of Robert Mallock, Beneficial Management Corp., Tr. 9602, and Michael Nelson, Legal Aid and Defender Association of Kent County, Tr. 4815.

[35] *See* finance company consumer files R-XI-CIT 215; R-XI-CIT 217; R-XI-BEN 102; R-XI-BEN 20; R-XI-BEN 20; R-XI-BEN 43; R-XI-BEN 100.

[36] The NCFA survey determined whether finance company loans were secured or unsecured. The questionnaire treated loans secured by only a wage assignment as unsecured. HX-494, Exh. 5 (questionnaire). Illinois finance companies reported only 131 unsecured loans, but 396 loans with wage assignments. Thus, even if we assume that all unsecured loans are subject to wage assignments, a substantial number of reported wage assignment loans were also secured by other property. The same was true in Michigan, where finance companies reported 111 unsecured loans and 289 wage assignment loans, and in New York, where finance companies reported 170 unsecured loans and 332 wage assignment loans. *See* R-XIII-36.

[37] *See, e.g.*, William S. Ballenger III, Director, Michigan State Department of Licensing and Regulation, Tr. 8177; Land of Lincoln Legal Assistance Foundation, Post-Record Comments XV-244 at 3; finance company's consumer file HFC 0216 (wage assignment in effect unless 'no' typed into form).

[38] The record contains various estimates of the frequency with which wage assignments are actually filed with employers. Robert P. Shay testified that, based on the NCFA survey, less than five percent of wage assignments taken by finance companies are actually filed. HX-494 at 37. Other estimates range from 21 percent (NCCF survey, *supra* note 28) to over 50

Wage assignments in the form of payroll deduction plans are used frequently by state[39] and federal[40] credit unions. As discussed below, payroll deductions are excepted from the wage assignment prohibition in the rule.

In sum, the use of and restrictions on wage assignments vary considerably from state to state. Overall, the record shows that wage assignments are used in a significant number of consumer transactions, and they are prevalent in states where they are permitted.

D. Consumer Injury

The preponderance of record evidence establishes that consumers suffer substantial injury when wage assignments are used as a collection device.[41] Wage assignment, unlike garnishment, occurs without the procedural safeguards of a hearing and an opportunity to assert defenses or counterclaims.[42] The use of wage assignments causes interference with employment relationships, pressure from threats to file wage assignments with employers, and disruption of family finances.[43] Wage assignments are particularly harmful

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percent (National Consumer Law Center (NCLC) Survey of Credit Contract Practices (1977), HX-467).

[39] *See, e.g.*, Merle Jewell, Boeing Employees' Credit Union, Tr. 10903-12.

[40] *See, e.g.*, David White, National Association of Federal Credit Unions, HX-459 at 5-7.

[41] This record does not indicate that payroll deduction wage assignments result in consumer injury. They are therefore excluded from the prohibition in the rule. *See* discussion *infra* at Section F.

[42] The Supreme Court has held that prejudgment wage garnishment violates due process rights. *See* discussion of *Sniadach* v. *Family Finance Corp.*, 395 U.S. 337 (1969), *supra* note 4. Prejudgment wage assignment, however, is not unconstitutional in most jurisdictions, but this result is largely because courts do not find sufficient state action to trigger due process protections. *See* discussion *supra* at Section A.

[43] *See infra* text accompanying notes 50-53 and 59-64.

because they cause injury to consumers who may have valid reasons for nonpayment.[44] [7758]

Additionally and importantly, the record shows that debtors are not aware of the rights provided to them by state law.[45] In Illinois, for example, upon default the creditor must inform the debtor of the right to notify the employer and the creditor of any defense.[46] The debtor can then contest the wage assignment by serving a notarized "notice of defense" to the credit by registered or certified mail.[47] Although designed to be protective, the statutory scheme does not accomplish its purpose because debtors do not understand the procedural notice of defense requirements and, more importantly, do not understand what a defense is and therefore do not know if they have one.[48] As a consequence, despite the existence of state statutes, many wage assignments result in collection by creditors even when there have been a breach of warranty,

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[44] The Presiding Officer found that "wage assignment is the contractual equivalent of garnishment except that it permits the seizure of wages without the opportunity for a hearing or an impartial determination of whether or not, under the circumstances, the creditor is entitled to receive payment of those wages." Presiding Officer's Report at 124, *citing* James H. Hiatt, Legal Aid Society, Oklahoma County, R-I(c)-14 at 2. *See also* George J. Wallace, University of Iowa Law School, HX-492 at 20; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, HX-79 at 14-15.

Garnishment may also cause interference with employment relationships, pressure from threats to file the garnishment, and a disruption of family finances. The key distinction is that the potential injury for garnishment results only after the creditor has obtained a judgment and the debtor has had the opportunity to assert defenses and counterclaims. What renders wage assignments unfair is that, without a hearing, they may cause injury even to those who legitimately owe nothing to the creditor.

[45] *See* Presiding Officer's Report at 128; Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3356-57; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2143-45; Karl R. Flodstron, Family Counseling Service of Aurora, Tr. 4847; James Baker, Onondaga Neighborhood Legal Services, Tr. 10781.

[46] Ill. Ann. Stat. ch. 48, § 39.2b (Smith-Hurd 1976).

[47] Ill. Ann. Stat. ch. 48, § 49.4a (Smith-Hurd Supp. 1983-84).

[48] Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2143-44.

fraud, or other violation of law that may constitute a defense to payment.[49]

The rulemaking record establishes that wage assignments cause serious and detrimental interference with employment relationships. Employers are hostile to wage assignments, and loss of employment for the debtor is possible.[50] Promotions, pay raises, job assignments, and other employment factors may be adversely affected. Employers resent the added

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[49] *See, e.g.*, William Ballenger, Michigan Department of Licensing and Regulation, Tr. 8178; Legal Assistance Foundation of Chicago, Post-Record Comments XV-252 at 5-7; James Baker, Onondaga Legal Services, Tr. 10782-83.

In an early study of wage assignments in Chicago, the author concluded that over 40 percent of the 432 wage assignments investigated by the Legal Aid Bureau of Chicago were legally unenforceable. Fortes, *Wage Assignments in Chicago*, 42 Yale L.J. 526, 537 (1932).

[50] George Corsetti, Michigan Association for Consumer Protection, Tr. 10499-501; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2146; Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, R-II(d)-128. Other files also contain statements by employers that wage assignments will lead to job loss. *E.g.*, R-X1-AVCO-149 (Ledger entry for 10/20: "Tel [telephone] B/A [business address] spk to Mr. ____, they deducted about $80 to send today, he is getting tired of handling the wage will definitely let them go it they have another wage."); R-XI-AVCO-562 Ledger entries 12/16 "WA sent," 12/23 "TBA [telephoned business address] S/W [spoke with] Pers. [personnel department?]—Mr. ____ customer will be warned has 30 days to clear up or be fired."); R-XI-HFC-216 (Ledger entry 1/7 "Job Pho Mr. ____ says must make arrangements to release W/A or O/C [our customer] to lose time & or job. Advise OK we release but if O/C late 1 time we to resent & never release."); and R-XI-HFC-234 (Ledger entry 4/15 "Job pho . . . Claims if we used WA cust would be fired."). Other files also evidence job loss due to wage assignments. *See, e.g.*, R-XI-HFC-77 (several ledger card references to employer threats to fire as result of wage assignment. Another ledger notation states "[employer] won't pay filed wages on both [debtor and wife], he fired her job, won't honor wage."); R-XI-AVOC-160 (Ledger entry for 7/21/71 says that, according to neighbor who was also personnel manager for debtor's former employer, "She [debtor's wife] lost her job because of W/A's and garnishments."); and R-XI-CIT-208 (Ledger entries 9/1/71" . . . said he will lose job if we don't lift wage."; 11/10/71 "T.H. [telephoned home]

administrative expense of wage assignments,[51] fear that the employee's job motivation will be affected, and view the failure to repay debts as a sign of irresponsibility.[52] The Consumer Credit Protection Act[53] prohibits an employer from dismissing an employee whose wages are garnished for any one indebtedness, but the Act does not apply to wage assignments.

During the proceeding, some creditors argued that state laws adequately protect against consumer injury and make the wage assignment prohibition unnecessary.[54] For example, New York and Illinois prohibit employers from dismissing or suspending employees because of wage assignments.[55] Although there is evidence that these statutes reduce job loss to some extent,[56] the protection offered by state law is limited and the record shows that a number of factors reduce the effectiveness of state protections. For example, in New York reinstatement is discretionary with the court;[57] in Illinois no statutory damages are provided.[58]

Spoke to wife she said he got laid off."; 11/11/71 "T.B. [telephoned business] Verified He laid off for 5 wks."). *See also* William Ballenger, Tr. 8178; Ray Andrus, Tr. 8783.

[51] *E.g.*, Jerrold Oppenheim, Legal Assistance Foundation of Chicago, Tr. 2146; George Corsetti, Michigan Association for Consumer Protection, Tr. 10501-02.

[52] Peachtree Bank, R-II(a)-89; James Hiatt, Legal Aid Society, Oklahoma County, R-I(c)-14 at 7. Thomas M. Dalton, Farmers & Merchants State Bank, R-II(g)-63.

[53] 15 U.S.C. 1674(a) (1982).

[54] *E.g.*, Rebuttal Submission of NCFA, R-XIII-31 at 60-61; Leonard M. Cohen, Independent Finance Association of Illinois, R-II(g)-147; Clarence Naborowski, Illinois Consumer Finance Association, Tr. 3846-47.

[55] N.Y. Civ. Prac. Law § 5252 (McKinney 1948); Ill. Ann. Stat. ch. 48, § 39.11, section 10 (Smith-Hurd Supp. 1983-84).

[56] *See* Clarence Naborowski, Illinois Consumer Finance Association, Tr. 3846-47; Alfred Orlin, New York State Consumer Finance Corporation, Tr. 11402-05.

[57] N.Y. Civ. Prac. Law section 5252(2) (1978).

[58] The Illinois statute provides that violation is a class A misdemeanor. Ill. Ann. Stat. ch. 48, section 39.11 § 10 (Smith-Hurd Supp. 1983-4.)

Wage assignments also cause serious consumer injury when used as a threat to obtain payment.[59] The pressure from these threats may cause consumers to abandon legitimate defenses to prevent the creditors from contacting the employers.[60] Consumers fear that the wage assignment will result in job loss,[61] and the record indicates that creditors exploit that fear[62] despite the fact that job loss would be economically counterproductive to the creditor. State wage assignment statutes do not offer protection from this type of injury. Most threats are made before the wage assignment is filed, but state statutes usually govern only procedural and post-filing rights.

Wage assignments also cause disruption of the family's finances and make it difficult for the debtor to purchase necessities.[63] This disruption can result in costly refinancing

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[59] The rulemaking record establishes that creditors threaten debtors with wage assignments. *See, e.g.*, R-XI-CIT-218, R-XI-CIT-216, R-XI-BEN-9, R-XI-HFC-216, R-XI-BEN-102, R-XI-BEN-115, R-XI-BEN-43, R-XI-CIT-236, R-XII-CIT-214, R-XII-CIT-208.

Respondents to the NCLC survey *supra*, note 38, estimated that when a wage assignment exists and a default is declared, the wage assignment is "used to threaten or harass" 65 percent of the time. HX-468, HX-469 (question K08).

[60] Presiding Officer's Report at 124; Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3356-57.

[61] *Id.* Even if state statutory restrictions prohibiting dismissal due to wage assignments were completely effective when wage assignments are actually filed, the restrictions do not protect against consumer fear of job loss that could lead to payment in response to threats to invoke a wage assignment.

[62] *See, e.g.*, Robert J. Abrahams, Tr. 9819-20; Ray Andrus, Tr. 8783.

[63] Presiding Officer's Report at 115. *See also* Beverly Ortiz, Consumer Protection Division, Office of the Attorney General of New Mexico, R-I(d)-46; Jerrold Oppenheim, Legal Assistance Foundation of Chicago, HX-79 at 16; Andrew Eiler, Consumer Affairs Department, United Auto Workers, R-I(d)-92 at 13; Michael Nelson, Legal Aid Society of Kent County (Michigan), Tr. 4815-16.

or the impossibility of discharging other obligations in a timely fashion.[64] [7759]

In the absence of procedural safeguards, the potential for severe, substantial disruption of employment, the pressure that results from threats to file wage assignments, and the disruption of family finances constitute significant consumer injury. State law is inconsistent and does not offer sufficient protection to prevent this consumer injury.

E. Offsetting Benefits

Commenters who opposed the wage assignment prohibition submitted that wage assignments are important for borrowers who are bad credit risks or who have no other type of security,[65] and that wage assignments keep collection costs down.[66] Other commenters, usually credit unions, maintained that payroll deduction wage assignments are used for the convenience of borrowers and that they reduce handling costs.[67] A few commenters emphasized that instead of a prohibition against wage assignments, the prohibition should be

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[64] Respondents to the NCLC survey, *supra* note 38, estimated that the use of wage assignments results in delinquency on other debts 53 percent of the time, HX-468 (question K09H), and results in costly refinancing over one-third of the time, HX-468, (question K09N).

[65] *Consumer Credit in the United States*, Report of the NCCF (1972) at 31; Harry A. Burn, National Association of Consumer Credit Administrators, Tr. 8866; Anne K. Bingaman, New Mexico Consumer Finance Association, Tr. 2098; Don L. Pratt, Indiana Consumer Finance Association, Tr. 3092.

[66] *See* Presiding Officer's Report at 123, *citing* George H. Braasch, Committee of Consumer Credit, American Bar Association, R-I(d)-76 at 7; James A. White, Council of State Credit Institutes, HX-461 at 8; Arthur H. Northrup, Indiana Consumer Finance Association, Tr. 3138; Alfred E. Orlin, New York State Consumer Finance Association, Tr. 11401.

[67] Tilman R. Thomas, Jr., Government Employees Credit Union, Tr. 838-39; Calvin Phillips, Texas Credit Union League, Tr. 563-64; T.J. Ryan, Albuquerque Bell Federal Credit Union, R-II(d)-5; Steven Knigge, Black Hills Federal Credit Union, R-II(b)-93; Herman Nickerson, National Credit Union Administration, R-I(a)-467; Jonathan Kindley, Credit Union National Association, R-I(a)-378; William Waysman, Northrup Credit

against employers who discharge employees because of wage assignments.[68]

The Presiding Officer discussed the importance of wage assignments to borrowers who are bad credit risks or whose paycheck is their only asset.[69] Creditors frequently consider wage assignments to be a form of security analogous to collateral.[70] In states that statutorily limit the amount of an unsecured loan that can be made by a creditor, a wage assignment may be sufficient security to avoid such limitations.[71] Thus, a wage assignment may allow consumers with no other collateral to obtain a secured loan. Record evidence indicates, however, that in a substantial number of loans secured by wage assignments, other security was also provided.[72] Furthermore, in almost every state, garnishment is available as an alternative method of collection.[73] Considering that garnishment includes procedural protections not required in

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Union, R-II(d)-127; Austin Montgomery, National Credit Union Administration, R-I(c)-815; Joan Morton, California Credit Union League, Tr. 7177; David White, National Asssociation of Federal Credit Unions, HX-459.

[68] *See, e.g.*, Hawaii Credit Union League, Post-Record Comments XV-272; National Consumer Finance Association, Post-Record Comments XV-343 at 132.

[69] Presiding Officer's Report at 123. *See also supra* note 65.

[70] *See, e.g.*, Alfred Orlin, New York State Consumer Finance Corporation, Tr. 11400-01; Betty Gregg, Credit Union National Association, Inc., Tr. 9662; Consumer file CIT 215 (ledger card with box labeled "security" filed in "LIFE A&H HHG 2WA", meaning that the loan is secured by life and accident and health insurance, household goods, and two wage assignments). *See also* Harold T. Welsh, Illinios Credit Union League, Tr. 4095-96.

[71] Presiding Officer's Report at 122 & n. 37 *citing* Merle Jewell, Boeing Employees' Credit Union, Tr. 10903-12 (discussing state statutory limitations on unsecured loans by credit unions). *See also* Harold T. Welsh, *id.* at 4096.

[72] *Supra* note 36.

[73] Virtually every state has statutory provisions governing garnishment. *See* CCH Consumer Credit Guide ¶660 for an overview of state garnishment statutes.

wage assignments,[74] the benefit of wage assignments is considerably diminished.

Creditors favoring wage assignments argued that they save the cost of going to court.[75] That argument does not, however, justify irrevocable wage assignments. In an undisputed case, court costs will be moderate. Although costs are greater in a disputed case, the costs are justified because it is precisely when the debtor has a defense that a court hearing is most valuable. With a wage assignment that is revocable at the will of the debtor, the debtor can chose either to save court costs by allowing the assignment or to revoke the assignment and raise defenses. Even if the debtor does not prevail, he or she will still have the statutory garnishment protections that apply to collection of a judgment.[76]

Credit unions maintained that wage assignments benefit consumers because they are an important method of keeping transaction costs down.[77] If a wage assignment is essentially a payroll deduction payment plan, the benefits outweigh the costs because the potential for the type of injury that this rule seeks to prevent[78] is nonexistent.

The evidence, therefore, supports our finding that consumers and competition do not receive countervailing benefits

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[74] Prejudgment garnishment is unconstitutional. *See supra* text accompanying notes 4-7.

[75] *E.g.*, Leonard Cohen, Independent Finance Association of Illinois, R-II(g)-147; Joseph Park, Michigan Consumer Finance Association, Tr. 3180; David Fredrickson, Airline Pilots Association Federal Credit Union, R-II(d)-3. Michael Brown, United Auto Dealer Association, Tr. 2766. *See also supra* note 66.

[76] *See supra* note 26. The statutory protections will also apply if the debtor allows a default judgment.

[77] *E.g.*, Betty Gregg, Credit Union National Association, HX-397; *But see* Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, HX-128 and Tr. 3379 (discussing need to assure true voluntariness).

[78] With a payroll deduction, the employer is aware of the plan from the outset of the transaction. Thus, there is no likelihood that the wage assignment will disrupt employment, and threats to file a wage assignment would be meaningless.

sufficient to offset consumer injury caused by the use of wage assignments unless the wage assignment is revocable at the will of the debtor or is a payroll deduction plan. Commenters considered that the loss, or fear of loss, of job and the deprivation of procedural protections do not justify the limited usefulness of this remedy.[79]

Furthermore, existing patterns and practices make clear that banning wage assignments will have little impact on the business of creditors other than finance companies. Banks and retail trade associations submitted that the rule provision on wage assignments would have little impact on their businesses.[80]

There is evidence that a ban on wage assignments will have no effect on the aggregate volume of credit extended,[81] but that a ban may lead to an increase in the rejection rate of finance company applications.[82]

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[79] Presiding Officer's Report at 125, *citing* Deborah S. Oseran, Assistant Attorney General, Arizona, Tr. 1035; William S. Ballenger, III, Director, Michigan State Department of Licensing and Regulation, Tr. 8178; and Thomas Crandall, Associate Professor of Law, Gonzaga University School of Law, Tr. 10665.

[80] James Goldberg, American Retail Federation, Tr. 8115-16 (rule provision "will have absolutely no effect on the vast majority of retailers."); K. E. Buhrmaster, New York State Bankers Association, R-I(a)-260 at 2 ("The prohibition against wage assignments, while contrary to specific New York statutes, is not repugnant to banks since they generally do not use wage assignments."). An American Bankers Association spokesperson discussed peripheral issues concerning wage assignments but did not argue that they are important to banks as a collection device. William Gwennap, American Bankers Association, Tr. 12199-200.

[81] Aho, *et al.*, Federal Trade Commission Proposals for Credit Contract Regulations and the Availability of Consumer Credit, R-XI-10 at 83.

[82] NCCF Technical Studies, Vol. V., *supra* note 28 at 131-40. *But see* Aho, *id.* at 68-101 for a criticism of the survey from which this conclusion is taken.

[footnote continued]

A study of the cost effects of wage assignment restrictions found no statistically significant effects from the restrictions,[83] but there is some evidence predicting that a prohibition would affect consumers from whom a [7760] wage assignment is required to secure a loan.[84] In addition to formal studies, there is evidence that state restrictions on wage assignments have been of limited importance. With minor exceptions,[85] the record does not show that finance companies or other creditors do business in a different way, or serve a different clientele, in states that do and do not permit wage assignments. Thus, prohibiting wage assignments will not significantly affect the credit market.

The Presiding Officer found that "so long as the remedy of garnishment is available, creditors could extend credit to the class of consumers from whom a wage assignment is ordinarily required without suffering an undue increase in costs."[86] In fact, there is evidence that wage assignments do not provide a significant savings in legal costs.[87] The record also

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[83] G. Bentson, "The Costs to Consumer Finance Companies of Extending Consumer Credit," NCFF Technical Studies, Vol. II, at 152-153. Bentson found some statistically weak evidence (not significant at the .05 level and not completely consistent) that, in response to restrictions on wage assignments, finance companies adjust their behavior in ways that result in higher losses but lower operating costs to produce a higher net profit. *Id.* at 138-39, 152. *But see* Robert P. Shay, R-XI-185A for a criticism of Bentson's work.

[84] *See supra* notes 69-72 and accompanying text.

[85] *See, e.g.*, Harvey Miller, Gateway Loan Company, Tr. 2529.

[86] Presiding Officer's Report at 308.

[87] Data from the NCFA survey show that creditors use legal process with the same frequency whether or not there is a wage assignment. Of 1,217 accounts including wage assignments, 1.4 percent were collected through an attorney. (Wage assignments from California were excluded because they are not used as a collection device and therefore would not affect legal costs.) In comparison, only .85 percent of all accounts were collected through an attorney. Judgments were obtained in 1.1 percent of wage assignment accounts, but only .96 percent of all accounts. Figures from HX-495, HX-496, HX-497. *See also* NCFA Data Tape, 215-42-1-12 [2-2] (physical exhibit, Section: 7, Shelf 2).

shows cases where creditors had wage assignments but chose to sue and then garnish the debtor's wages.[88] The fact that creditors voluntarily elect to forego use of wage assignments even when they have them is a strong indication of limited utility.

The Presiding Officer concluded that prohibiting wage assignments "would be of economic benefit to low-income or poor consumers, since it would no longer be possible to use this device as a means for interjecting the creditor into the employer-employee relationship without court action."[89] The preponderance of evidence establishes that the marginal benefit of irrevocable wage assignments to creditors is limited, especially with the availability of garnishment as an alternative remedy, and that any effect of banning wage assignments on overall credit availability will be small.[90]

F. Alternatives Considered and Modifications Adopted

The initial proposed rule would have banned wage assignments entirely. Based on the record, we have made four modifications to the promulgated rule. First, the rule will not apply to wage assignments that by their terms are revocable at the will of the debtor. Second, the rule does not prohibit payroll deduction plans or similiar preauthorized payment plans commencing at the time of the transaction in which the consumer authorizes a series of deductions as a method of making each payment. Third, the rule will not apply to wages already earned at the time of the assignment. Fourth, a definition of the term "earnings" was taken from the Uniform Consumer Credit Code and added to the proposed rule to clarify its coverage.

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[88] *See, e.g.*, consumer files R-XI-CIT-214, LIB-340, LIB-345, LIB-347, LIB-355, LIB-375, LIB-380, LIB-381, BEN-147, BEN-113, CTA-126, CTA-153, GFC-430.

[89] Presiding Officer's Report at 308.

[90] The marginal benefit of payroll deductions and wage assignments that are revocable at the will of the debtor is greater and outweighs the potential for injury, if any, arising from their use. Thus, these wage assignments are exempted from the rule.

The first change is designed to allow consumers to enter into noninjurious revocable wage assignments to minimize transaction costs.[91] To fit within this exception the wage assignment must be revocable by its terms; therefore the wage assignment itself must include language that establishes revocability.[92] The wage assignment also must be revocable at the will of the debtor. This will allow the debtor to stop the wage assignment before injury occurs.

The second change is designed to permit credit unions and other creditors to continue to use voluntary payroll deduction plans as a repayment device, and to clarify that the rule does not prohibit preauthorized electronic fund transfers.[93] The

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[91] Many commenters supported an exception for revocable wage assignments. *E.g.*, National Consumer Law Center, Post-Record Comments XV-324 at 13-17 (but emphasizes that assignment must be "easily terminable"); James L. Brown, University of Wisconsin Center for Consumer Affairs, HX-153 at 4; Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3379 (no opposition to revocable wage assignments if truly voluntary); Michael S. Milroy, Valley National Bank of Arizona and National Banking Association, Tr. 5458; Tom D. McEldowney, Idaho Department of Finance, Tr. 5058-59.

[92] Although we do not promulgate an express provision requiring specific language or notice of the right to revoke, hidden revocability disclosures or attempts to obfuscate revocability may themselves constitute unfair or deceptive practices under Section 5 of the Federal Trade Commission Act. *See, e.g., In re All-State Industries, Inc.*, 75 F.T.C. 465, 489-94 (1969), *aff'd*, 423 F.2d 423, 425 (4th Cir.), *cert. denied*, 400 U.S. 828 (1970) (required credit disclosure must be made with "conspicuousness and clarity"); *New York Jewelry Co.*,74 F.T.C. 1361, 1409, *aff'd, sub nom. Tashof* v. *FTC*, 437 F.2d 707 (D.C. Cir. 1970) (policy that lured consumers into "contractual obligations which in all likelihood they have little understanding of" found "manifestly unfair"); *Beneficial Corporation*, 96 F.T.C. 120 (1980) (consent order) (misleading disclosures in credit transaction); c.f., *Raymond Lee Organization*, 92 F.T.C. 489 (1980), *aff'd*, 679 F.2d 905 (D.C. Cir. 1980) (ambiguous contract disclosures and insufficient disclaimers); *Bantam Books, Inc.* v. *FTC*, 55 F.T.C. 779 (1958), *aff'd*, 275 F. 2d 680 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960) (inadequate disclosure of book abridgment).

[93] Electronic fund transfers are governed by the Electronic Fund Transfers Act, 15 U.S.C. § 1693 *et seq.* (1982); preauthorized transfers are revocable by statute. 15 U.S.C. § 1693e (1982); 12 C.F.R. § 205.10(c) (1983).

exception for payroll deduction plans is consistent with the intent of the rule and with the record evidence. The rule is intended to address collection remedies, but a payroll deduction plan is a method of making payments on an obligation.[94] Thus, consumer injury does not result from its use.[95] The record contains substantial support for an exception to the rule for payroll deductions.[96] Some commenters recommended that a definition of wage assignment be included in the rule to clarify that payroll deductions are not affected;[97] we accomplish the same result by the exception we promulgate.

The third change is intended to eliminate a problem in California where certain creditors must take assignments of earned wages or a security interest in personal property to qualify for higher loan interest rates. Small loan companies take assignments of earned wages to qualify as personal property brokers under the state law.[98]

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[94] For a description of a credit union payroll deduction plan, *see* Merle B. Jewell, Boeing Employees Credit Union, Tr. 10909.

[95] *See supra* note 78 and discussion of consumer injury, *supra* Section D.

[96] *See supra* note 67. Some credit union policies require a wage assignment to be irrevocable if the assignment is to constitute security for a loan. Merle B. Jewell, Boeing Employees Credit Union, Tr. 10903; Post-Record Comment XV-101. *See also* Hawaii Credit Union League, Post-Record Comment XV-272. Both revocable and irrevocable payroll deductions are permitted under this rule.

[97] David White, National Association of Federal Credit Unions, HX-459 at 5-7; Endicott Employees Federal Credit Union, Post-Record Comment XV-82 at 1.

[98] The Constitution of California establishes an interest ceiling of 10 percent but excepts from that ceiling every significant class of consumer lenders, including personal property brokers. Cal. Const. Article XX section 22. At the time the Constitution was adopted, personal property brokers were defined by statute as those engaged in the business of lending money and taking as security for such loans either a contract involving the forefeiture of rights in or to personal property, the use and possession of which is retained by other than the lender, or a lien on, assignment of, or a power of attorney relative to wages, salary, earnings, income, or commissions. *Budget Finance Plan* v. *Gamson*, 34 Ca.. 2d 96, 207 P.27 825 (1949).

Some legal aid agencies opposed this exemption on the grounds that: (1) Earned wages are part of a low income debtor's subsistence, and (2) debtors have no bargaining power over the terms of wage assignments.[99] We find [7761] that the record demonstrates that consumer injury from assignment of earned wages is minimal, and outweighed by offsetting benefits to consumers or competition.

We have also added the U.C.C.C.'s definition of "earnings" to the initial proposed rule to clarify the types of income to which the provisions applies. This responds to industry suggestions that such a definition will facilitate compliance and add certainty to the rule.[100]

The National Commission on Consumer Finance recommended a ban on wage assignments for credit transactions involving over $300. It advised allowing assignments for transactions of $300 or less, but only for otherwise unsecured loans, and only on the condition that the assignment not exceed the lesser of: (1) 25 percent of the debtor's disposable earnings for any workweek, or (2) the amount by which his or her disposable earnings for the workweek exceed 40 times the federal minimum hourly wage prescribed by section 6(a)(1) of

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The present definition contained in section 22009 of the California Personal Property Brokers Law is the same as that contained in the law in effect when the constitution was adopted. George R. Richter, California Loan and Finances Association, Tr. 5860-67. It has been held that to secure the benefit of the constitutional waiver from the interest ceiling of 10 percent personal property brokers' loans must be secured in whole or in part by a security interest in personal property or by a wage assignment. *Id.* Therefore, an absolute prohibition of wage assignments would severely limit, if not totally end, loans by personal property brokers in California. To avoid this result, the rule was modified to permit assignment of wages already earned.

[99] *See* Southern New Mexico Legal Services, Inc., Post-Record Comments XV-146 at 2-3; Legal Aid Bureau, Inc., Post-Record Comments XV-242 at 5.

[100] *See* Legal Assistance Foundation of Chicago, Post-Record Comments XV-252 at 9; United Bank of Denver, Post-Record Comments XV-110 at 2; New Orleans Legal Assistance Corporation, Post-Record Comments XV-314 at 5.

the Fair Labor Standards Act of 1938 in effect at the time.[101] The Commission considered this approach, but we rejected it because the record shows that the injury caused by the use of wage assignments bears no relation to the size of the loan.[102] Use of an irrevocable wage assignment in small as well as large loans could result in interference with employment, injurious pressure from threats to file the assignment, and disruption of family finances, all without a hearing and an opportunity to assert defenses.

VI. Security Interests in Household Goods

A. Introduction

In return for the credit they receive consumers are often required to give their creditors a security interest in the property they own at the time credit is extended or may obtain after the credit transaction is consummated. Although creditors have made secured loans since the beginning of recorded history, the use of non-possessory liens on personal property is a comparatively recent development. Non-possessory security interests were not recognized at common law.[1] Since the beginning of this century, however, loans secured by non-possessory liens on debtors' household goods and personal effects have become increasingly common.[2]

Specifically addressed by this rule provision is a lien on a consumer's household goods taken in connection with a loan.

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[101] NCCF Report, *supra* note 65 at 31. The $300 maximum recommended by the National Commission on Consumer Finance was apparently taken from the Uniform Small Loan Act adopted in 1917 when the dollar was worth far more than it is today. *See* Professor Robert P. Shay, NCFA, HX-494 at 39-40.

[102] *E.g.*, Richard Alpert, National Consumer Law Center, R-I(d)-85 at 20; Richard Halliburton, Legal Aid of Greater Kansas City, R-I(c)-29.

[1] Robinson and Nugent, *Regulation of the Small Loan Business* (1935), 18-19, 21. The common law, for most of its history, did not sanction non-possessory security interests in personal property, invalidating all such interests. *Twinne's Case*, 76 Eng. Rep. 809 (Star Chamber 1601).

[2] Robinson and Nugent, *supra* note 1, at 37, 40.

The security interest in household goods gives rise to a right to seize property from a consumer, with the potential of inflicting a substantial forfeiture on the consumer. The rule at Section a(4) prohibits the use of security interests in household goods, as defined, in non-purchase money transactions,[3] while permitting the pledge of certain possessions that creditors regard as valuable collateral.

B. State Law

Security interests are creatures of statute, inasmuch as non-possessory liens were not recognized at common law.[4] Prior to the adoption of the Uniform Commercial Code (U.C.C.), a variety of different "security interests" were created by a variety of different statutes.[5] The U.C.C. eliminated all distinctions between security devices that preexisted it, distinguishing only between purchase money security interests and other interests. It cumulated all remedies available to secured creditors and reduced to a minimum the procedural formalities necessary to create a security interest. Today, Article 9 of the U.C.C. is the predominant

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[3] The Uniform Commerical Code defines the term "purchase money security interest" as follows:

> A security interest is a purchase money security interest to the extent that it is
>
> (a) Taken or retained by the seller of the collateral to secure all or part of its price; or
>
> (b) Taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used. U.C.C. section 9-107 (1978).

We address the question of what happens to an existing purchase money security interest when the loan is refinanced or consolidated *infra* at note 97.

[4] *Twinne's Case*, 76 Eng. Rep. 809 (Star Chambers 1601).

[5] For a list of statutes superseded by the U.C.C., see U.C.C. Official Text xxxiii, *et seq.* (1967). *See also* 1 Gilmore, Security Interests in Personal Property (1965); Gilmore and Axelrod, *Chattel Security*, 57 Yale L. J. 517 (1947); Gilmore, *The Secured Transaction Article of the Commercial Code*, 16 Law Contemp. Probs. 31 (1951).

law governing use of security interests in consumer transactions.[6] Article 9 affords creditors with maximum flexibility as to the terms contained in security interests, including coverage, description of property, and circumstances under which seizure may take place. The description of property required is minimal.[7] Creditors can often retain a security interest in all of a debtor's "household goods" by simply checking a box on a standard form.[8]

Statutory limitations on a creditor's capacity to secure a consumer obligation fall into three categories. The first consists of statutes regulating installment sale transactions where seller and initial creditor are the same entity. Most states have enacted statutes restricting installment sellers to a lien on goods sold.[9] In a few states additional limitations have been imposed on direct lenders.[10] Thus, most **[7762]**

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[6] The sole exception is Louisiana, a civil law jurisdiction. Louisiana debtors are required to execute a notarized mortgage of chattels which gives rise to a right to proceed in summary process in the event of a default. La. Civ. Code art. 2234. The debtor is held to confess his obligation in the notarial instrument and the creditor may foreclose his lien in accordance with a two step confession of judgment theory. La. Civ. Code art. 263. Louisiana also permits installment sellers to retain a "privilege" in the goods which is analogous to a purchase money lien. La. Civ. Code art. 3186. There are no limitations on the amount of property a creditor may take as security, and blanket security interests are common in Louisiana.

[7] *E.g.*, Op. Ky. Att'y Gen. (April 12, 1968) that validated the use of the terms "household goods."

[8] Allen Kamp, Northwest Legal Services, R-II(f)-125, Exh. A.

[9] Retail installment sales acts reflect "conditional sale" concepts. *E.g.*, Arizona Rev. Stat. title 44, ch. 16, art. 1544. The Uniform Consumer Credit Code (U.C.C.C.) at § 2-407 also limits installment sellers to a lien on the goods sold. The U.C.C.C. has been adopted in nine states (Colorado, Indiana, Iowa, Kansas, Maine, Wyoming, Oklahoma, Idaho, and Utah). The Wisconsin Consumer Act at section 522.417, does the same thing.

[10] *E.g.*, Wisconsin Consumer Act section 422.417 reads "With respect to a consumer loan, a lender may not take a security interest other than a purchase money security interest in: Clothing of the customer and his dependents and the following: Dining table and chairs, refrigerator, heating stove, cooking stove, radio, beds, and bedding, couching and chairs, cooking utensils and kitchenware." Connecticut prohibits non-purchase money

statutory limitations do not address the problem of non-purchase money security interests in household goods in consumer loan transactions, despite a predisposition to limit purchase money creditors to a lien on the goods in credit sales.

C. Prevalence

Based on the rulemaking record, we find that the practice of securing consumer loans with a non purchase money security interest in household goods (HHG)[11] is widespread. Finance companies are the preeminent users and HHG security interests are found in a majority of finance company loan contracts.[12] However, banks also avail themselves of such

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security interests in most consumer transactions, and purchase money is defined to include only installment sales. 42 Conn. Gen. Stat. 180. Maine prohibits any security interests in property that would otherwise be exempt from execution. Me. Rev. Stat. Ann. tit. 14, section 4401, (—), as do Iowa, Iowa Code Ann. section 537.3301, and Virginia, Va. Code sections 34-26, 34-28) (1976).

[11] The tern "HHG" is widely used by the consumer finance industry to describe a blanket lien on household goods. *See e.g.*, HX-129 at Exh. 3.

[12] HX-494 (Statement of Robert Shay on behalf of National Consumer Finance Association). Results of a survey of some 10,000 current consumer accounts revealed clauses authorizing HHG security interests in 76 percent of precomputed loan contracts and 70 percent of per diem loan contracts. HHG were actually taken as collateral in 62 percent of precomputed loans and 66 percent of per diem loans. *Id.*at 43.

See also, e.g., Harvey Miller, Gateway Loan Co., Tr. 2537; Hyman Weiner, Atlantic Finance Co., Tr. 6483; Robert Gage, Legal Aid Society of Mecklenburg County, Tr. 1268-69, 1297; Olin S. Pugh, South Carolina Consumer Finance Association, Tr. 9271; Kenneth Davis, Kentucky Consumer Finance Association, Tr. 1546; Dial Finance Co. Manual, R-DF-5; George Richter, Colorado Loan and Finance Association, Tr. 5869.

security[13] as do credit unions[14] and even, occasionally, savings and loan associations.[15] Although retail installment sales acts tend to restrict retailers to a purchase money lien on the goods sold,[16] the record also reveals that certain retailers rely on HHG security interests as additional collateral in credit sale transactions.[17]

An HHG security interest may be created by checking a box appearing in the text of a standard form agreement.[18] In such cases the description of covered property is cast only in general terms giving consumers little notice of the nature and extent of the collateral they are pledging to secure the loan.[19]

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[13] *E.g.* Thomas Huston, Iowa Banking Department, Tr. 2291; Willis Moreman, Kentucky Bankers Association, R-II(f)-163; Vern Kicks, Farmers National Bank, R-II(f)-181; R. C. Smith, Georgia Bank and Trust Co., R-II(f)-178; John Bennett, Park National Bank of Kansas City, R-II(b)-138; James Brown, Center of Consumer Affairs, University of Wisconsin, Tr. 4081; HX-413.

[14] Betty Gregg, Credit Union National Association, Tr. 9690; T. J. Ryan, Albuquerque Bell Federal Credit Union, R-II(d)-5; Tilman Thomas, Gov. EES Credit Union, Tr. 812; Harold Welsh, Illinois Credit Union League, Tr. 4097.

[15] C. C. Small, Texas Savings and Loan League, Tr. 1908.

[16] *See* Note 9, *supra*.

[17] *E.g.*, Allison Steiner, Central Mississippi Legal Services, Tr. 1764; Barry Powell, Community Legal Services of Mississippi, R-II(f)-66; Richard Halliburton, Legal Aid and Defender Society of Kansas City, Tr. 119-20; James Brown, Center of Consumer Affairs, University of Wisconsin, Tr. 4079-80; Robert Atkinson, Legal Aid County Legal Aid Society, Tr. 3669.

[18] *E.g.*, R-AVCO-51; R-ASSOC-165; R-BEN-25; R-LIB-268; R-CIT-393; R-CTA-144; HFC contract attached as Exh. A to Alan Kamp, Northwest Neighborhood Legal Services Association, R-II(f)-125.

[19] *E.g.*, R-AVCO-58 where contract reads "if checked at left, consumer goods consisting of all household goods, furniture, appliances, bric a brac and personal property of every kind and description * * * "; R-HFC-216 where the contract reads "Unless 'no' appears under chattel mortgage above there is a chattel mortgage security agreement on household and consumer goods"; R-ASSOC-165, where contract reads "All of the furniture, appliance, fixtures and other household goods of every kind and nature now located in or about Debtor's residence * * * "; and R-BEN-25

Consumers may thus be unaware, in a given instance, of what is subject to a security interest.[20] Under current interpretations of Article Nine of the U.C.C., the simple inclusion of the term "household goods" is sufficient to encumber all of the personal property owned by the consumer.[21]

On the other hand, there is evidence on the record that many finance companies do list security by preparing an inventory of all of a consumer's household property,[22] sometimes by asking consumers to give a list of the covered items either orally or in writing when the loan papers are filled out.[23] In these cases, and certainly where the consumer gives the inventory, there should be little question either that a security interest has been given or as to the scope of its coverage.

The majority of HHG security interests are taken in connection with extensions of credit made under small loan acts where the amount financed is limited, with the limit generally being between 1200 and 1500 dollars,[24] but HHG security

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where contract reads "The nature of security for this note is checked herein" and a small box adjacent to the word "furniture" is checked. *See also* Presiding Officer's Report at 160.

[20] Mary Gillespie, San Francisco Neighborhood Legal Assistance, Tr. 5592, David Tarpley, Legal Services of Nashville, Tr. 3765-66; Alan Kamp, Northwest Neighborhood Legal Services, R-II(f)-125. *See also* Presiding Officer's Report at 164-165.

[21] *E.g., In Re Drane*, 202 F. Supp. 211 (D.C. Ky. 1962).

See also Op. Ky. Att'y Gen. (April 12, 1968), which validates the use of the term "household goods" with reference to U.C.C. 9-110 and Op. S.C. Att'y Gen. No. 3156 (August 2, 1971).

[22] *E.g.*, Creighton Lynch, Southwestern Investment Co., Tr. 1859-60; John R. Shuman, Florida Consumer Finance Association, Tr. 3555; National Consumer Finance Association, Post-Record Comments XV-343 at 77; *see also* Post-Record Comments XV-269, 283, 301 and 342 at 267.

[23] *E.g.*, George W. Prentiss, Citizens Budget Co., Tr. 4214; Joseph C. Park, Michigan Consumer Finance Association, Tr. 3181; John R. Shuman, Tr. 3555.

[24] The median extension of credit reflected in the NCFA survey for all of the consumer loans surveyed was $1,231.00 for precomputed loans and $1,486.00 for per diem loans. HX-494

interests are frequently taken to secure smaller extensions of credit.[25] In this connection, HHG security is employed by finance companies which are licensed to lend no more than 300 dollars.[26]

The record reflects instances where cosigners as well as the primary debtor pledge all of their household goods when they guarantee the loan of another.[27]

State regulators and officials generally confirmed the widespread use of blanket HHG security interests[28] in consumer transactions, as did legal services attorneys who appeared in the hearings.[29] Thus, the record strongly supports our finding that the use of HHG security interests is frequent and widespread.

D. Consumer Injury

This record reflects the fact that household goods typically have little economic value in the resale market.

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[25] *E.g.*, all of the debtors' household goods secure the loan in R-BEN-154 ($375.00 loan); R-GFC-328 ($332.00 loan); R-BEN-152 ($242.00 loan); R-LIB-268 ($168.00 loan); R-CIT-367 ($600.00 loan); R-GFC-146 ($240.00 loan); R-GFC-154 ($64.00 loan); R-AVCO-487 ($277.00 loan); R-LIB-33 ($236.00 loan); and R-GFC-59 ($212.00 loan).

[26] James White, Council of State Credit Institutes (trade association for lenders of amounts less than 300 dollars), Tr. 11152

[27] *E.g.*, Hyman Weiner, Atlanta Finance Co., Tr. 6483; R-DIAL-156.

[28] *E.g.*, Mervyn Dymally, Lieutenant Governor of California, Tr. 6515; Thomas Huston, Superintendant of Banking, Iowa, HX-87 p. 48; Irvin Parker, Administrator, Department of Consumer Affairs, South Carolina, Tr. 9230; Senator Alan Susman, West Virginia, Tr. 4877-78.

[29] *E.g.*, Kathleen Keest, Black Hawk County Legal Aid, Tr. 4254; David Tarpley, Legal Services of Nashville, R-I(c)-95; Robert Atkinson, Legal Aid of Portland, Tr. 5638; Jonathan Epstein, Newark Legal Services, Tr. 8945; Steven McCabe, Legal Services of New Jersey, Tr. 8731; Robert Gage, Legal Aid of Mecklenburg County, Tr. 1268-69, 1282; Thomas Bothus, Legal Services of Eastern Michigan, Tr. 3058-59; Lawrence Mealer, Dallas Legal Services, Tr. 369; Daniel Hedges, Appalachian Research and Defense Fund, Tr. 11370.

> The value of security in the second hand market in most cases is much less than the consumer owes. It would be the exceptional loan where the furniture would be worth even one-half of the principal.[30][7763]

> We lend more than the furniture is worth.[31]

In this proceeding, a large majority of industry witnesses confirmed that household goods have little, if any, economic value to creditors.[32] Their value to creditors is psychological, as noted in the testimony of Helmut Schmidt, Vice Chairman of Transamerica Financial Corporation:

> There are two very, very important values to the furniture. One is the replacement value, the other is psychological, that may enhance sentimental values in heirlooms being provided and the negative of price, the loss thereof if a repossession takes place, et cetera. I couldn't possibly say whether replacement value or pride is the more important.[33]

The record reflects the fact that creditors rarely engage in actual repossession of household goods.[34] When it does occur,

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[30] R-GF-6 at p. 19.

[31] R-TF-5-1 at 6 (company Training manual: furniture appraisals).

[32] *E.g.*, Allen Hill, First State Bank of Columbus, R-I(a)-667; Kenneth Davis, Kentucky Finance Company, Tr. 1528, 1546; Helmut Schmidt, Transamerica Finance Corporation, Tr. 6234; Robert Dean, Security Mutual Finance Co., Tr. 186; Tom McEldowney, Idaho Department of Finance, Tr. 5093; Warren Wilfert, Bank of Pennsylvania, R-II(b)-3; Senator Ellis Bodron, Mississippi Consumer Finance Association, Tr. 295; Calvin Phillips, Texas Credit Union League, Tr. 587; Lester Sodowick, New Jersey Consumer Finance Association, Tr. 8392; Harvey Lynch, Glendale Federal Savings and Loan, Tr. 5209-10; Edmund Leong, Hawaii Consumer Finance Association, Tr. 5413.

[33] Tr. 6214.

[34] For instances of actual repossession *see, e.g.*, George Prentiss, Citizen's Budget Company, Tr. 4229-31; Earle Nelson, California Department of Corporations, Tr. 5012; Clare Rollwagen, Minnesota Consumer Finance Conference, Tr. 3933; Jonathan Epstein, Newark Legal Services, Tr. 8950; Stanley Calmes, Mississippi Consumer Finance Association, Tr. 280-81.

the furniture and other items seized frequently have little or no economic value;[35] occasionally, the act of seizure appears to be undertaken for punitive or psychological deterrent effect.[36]

Although seizure of household goods is rare, when it occurs it can have severe economic consequences. It may occur in the context of divorce, where a wife finds herself financially devastated and deprived of her personal belongs,[37] or without baby furniture,[38] or a refrigerator.[39] Repossessed furniture

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[35] The record contains examples of seizure which yields little or no economic benefit to the creditor. *E.g.*, R-ASSOC-163 (creditor buys all furniture for $35.00 at sheriff's sale); R-LIB-35 (furniture sold for $150.00); R-XI-LIB-558 (cookware for $45); R-XI-LIB-762 (baby furniture repossessed and sold for $50); Robert Atkinson, Consumer Unit, Legal Aid Service of Portland, Oregon (cost of repossession and storage exceeds value of household goods), Tr. 5918; case history, Summit County Legal Aid Society, R-I(c)-92.

[36] "Q. Did you ever have to junk it?

"A. Yes.

"Q. You have to junk some of it?

"A. Yes, and do you know why, are you interested?

"Q. Certainly.

"A. Let me pose this as a hypothetical case—it is not hypothetical, it is actual. You have a number of families in one area who will be borrowing from you. If this fellow continues to go down the drain and continues to ignore his obligation and you try everything in the world to get him to pay and he is laughing at you and saying—

"Q. You want to make an example of him for other people?

"A. Not necessarily an example. But if you don't you are going to charge off the whole block."

Carl Woxman, North Carolina Consumer Finance Association, Tr. 10256. The maintenance of credibility was offered as a reason for repossession by other witnesses; *e.g.*, Michael Burns, Legal Aid Society of Minneapolis, R-I(c)-99.

[37] Robert Atkinson, Consumer Unit, Legal Aid Service of Portland, Tr. 5918 (woman on public assistance loses furniture).

[38] R-XI-LIB-762.

[39] R-XI-CTA-502.

may be taken to the dump[40] or auctioned for a tiny fraction of its replacement value.[41] For the debtor, the replacement value is a true measure of the cost of the repossession.[42] Thus seizure often imposes a cost on the consumer which is seriously disproportionate to any benefit the creditor obtains.

In the context of seizure the disproportionate economic impact of non-purchase money security interests is most apparent. Debtors lose proper+y which is of great value to them and little value to the creditor.[43] The value to debtors consists primarily of the replacement cost of the goods seized, together with psychological and emotional value. The debtor is, in an economic sense, willing to pay more for the household goods then they are ever worth to the creditor on the resale market. Although creditors are entitled to payment, such security interests offer little economic return to creditors at great cost to the debtor.

When consumers run into difficulty, the non-purchase money security interest in household goods also enables a creditor to threaten the loss of all personal property located in the home. This psychological lever, referred to over and over again in this proceeding,[44] together with the cost to the

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[40] R-XI-AVCO-539.

[41] R-DIAL-183; R-XI-ASSOC-636; R-XI-CIT-267; R-XI-TA-79; Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, Tr. 3365.

[42] *See* Carol Knutson, Neighborhood Legal Services Association, Pittsburg, Tr. 11108, where a creditor advised the witness that furniture would simply be burned. *See also, e.g.*, Harvey Miller, Gateway Loan Co., Tr. 2545 (by implication); William Martin, Oregon Consumers Finance Association, Tr. 7563 (by implication) (borrowers place a sufficiently high value on HHG that repayment of the loan would be insured in accordance with the value the owner places on the security); Edmund Leong, Hawaii Consumer Finance Association, Tr. 5413.

[43] [MISSING IN ORIGINAL]

[44] *E.g.*, Earle Nelson, California Department of Corporations, Tr. 5035; Lawrence Mealer, Dallas Legal Services, Tr. 371-77; Edmund Leong, Hawaii Consumer Affairs Association, Tr. 5413; James Sullivan, Department of Consumer Affairs, Missouri, Tr. 45-96.[?]

consumer of replacing the security, gives this remedy its value to the creditor.

The preponderance of evidence on the record supports our finding that despite the limited economic value of household goods, creditors rely on the psychological lever to seek payment and to persuade consumers to take other actions the creditors may deem appropriate, such as refinancing or obtaining a cosigner.

> If in your discussion with the applicant you find that certain articles have a sentimental value because of the fact that they are family heirlooms or gifts, make a note of this on your appraisal for future use.[45]

In this connection, the National Consumer Law Center found that legal aid attorneys considered non-purchase money security interests the single most common basis for threats and harassment of consumers of all of the creditors remedies surveyed.[46] The findings of the NCLC survey are borne out by the testimony received in this proceeding.[47]

The consumer files on this record drawn from the offices of major consumer finance companies contain further examples of threats to seize household goods. Such use of psychological security is recorded on the backs of ledger cards which detail the collection contacts engaged in by the creditor,[48] and in correspondence appearing in the consumer files.[49] Threats

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[45] R-LL-5 at 4 (Household Goods—Estimated List, Outside Lookup and Appraisal, New Business #38).

[46] National Consumer Law Center (NCLC) Survey of Credit Contract Practices, Survey, HX-467 at 30-31 (1977).

[47] *E.g.*, Drew Johnson, Lane County Legal Aid, Tr. 6325. "In a clear majority of cases where the client is in default there is a threat to repossess household goods." *See infra* note 51.

[48] *E.g.*, R-DIAL-160; R-BEN-86 ("Work HHG on wife"); R-GFC-507; R-AVCO-140; R-AVCO-63 (threats to take furniture from welfare family with eight children); R-GFC-497.

[49] *E.g.*, R-DIAL-181; R-ASSOC-673; R-DIAL-189; R-CIT-316; R-TA-8; R-DF-1 at 18.

may be direct or indirect; they may be made to third parties as well as the principal debtor.[50] **[7764]**

> Chase and recheck is a psychological device in which the Dial office representative visits the uncooperative customer's home specifically for the purpose of rechecking the security * * * . Normally this will arouse concern on the part of the customer as to the reason for the rechecking. You are not to threaten that your branch is ready to repossess the security, merely advise the customers that you do not know the reason for the recheck, that you are just carrying out an assignment, and that if you were in similar circumstances you would contact the office immediately. R-DF1-27. (Dial Finance Company manual).

The record shows that consumer and industry witnesses acknowledge that security interests in household goods are used in a way which is uniquely threatening and disruptive to consumers and their families.[51] Ledger card entries in consumer files include directives such as as "work HHG on

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[50] *See, e.g.*, R-XI-185 (Beneficial Finance Company contacted the son of the debtors and threatened to seize his parents' household goods unless he assumed payment).

[51] *E.g.*, Eugene Thirolf, Land of Lincoln Legal Assistance Foundation, R-L(c)-20; Drew Johnson, Lane County Legal Aid, Tr. 6325 (threat to seize HHG in clear majority of cases of default); Royal White, White Systems of Jackson, Tr. 213 (term used was "advise" consumers); James Boyle, Texas Consumer Association, Tr. 16; Harvey Miller, Gateway Loan Co., Tr. 2545 (implied threat); Robert Loheit, Chapter 13 Trustee and former finance company officer, Tr. 5743; Carol Knutson, Neighborhood Legal Services Association, Pittsburgh, Tr. 11127; Kenneth Levin, Atlanta Legal Aid Society, Tr. 8275; Mervyn Dynally, Lieutenant Governor of California, Tr. 6527; Robert Gage, Legal Aid of Mecklenburg County, HX-44 at 2 (threat made to debtor's children); Kathleen Keest, Black Hawk County Legal Aid, HX-158 at 2; Lawrence Mealer, Dallas Legal Services, Tr. 371-72; Daniel Hedges, Appalachian Research and Defense Fund, Tr. 11370-171; Michael Nelson, Legal Aid Society of Kent County, Tr. 4822; Tom McEldowney, Department of Finance, State of Idaho, Tr. 5074; Roberta Ranstrom, Legal Aid Society of Sacramento, R-II(f)-205; Senator Ellis Bodron, Mississippi Consumer Finance Association, Tr. 295.

wife"[52] and similar instructions to apply pressure to family members by threatening destitution.[53] In some cases threats are directed to children and other family members.[54] In others, the creditor will appear at the home and terrify the whole family.[55]

Certain witnesses testified that such threats were never made.[56] Although the Commission recognizes that certain individual creditors may refrain from threatening to seize household goods, the preponderance of evidence supports a conclusion that such threats are commonplace.

A threat to seize family possessions from the home of a consumer is psychologically debilitating and disruptive.[57]

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[52] R-BEN-86; *see also* R-DIAL-160, (ledger card entry reveals pressure on wife of debtor), R-XI-DIAL-24, (pressure was applied to wife after husband had a stroke).

[53] *E.g.*, R-DIAL-24; R-AVCO-63; R-XI-GFC-190 ($154 owed); R-XI-GFC-497; R-XI-HFC-184, 187, 189; R-XI-TA-8.

[54] *E.g.*, Lois Wood, Land of Lincoln Legal Assistance Foundation, R-I(c)-19 (loan company employee calls his office from debtor's home and describes furniture while wife is present); Robert Gage, Legal Aid of Mecklenburg County, Tr. 1256; James Kocher, Lane County Legal Aid, Tr. 6376 (debtor with six children, the threat itself is injurious). *See also* R-XI-DIAL-183.

[55] Michael Nelson, Legal Aid Society of Kent County, Tr. 4811 (creditor appears with a moving van and threatens to empty the house); Roberta Ranstrom, Legal Aid Society of Sacramento County, R-II(f)-206 ("Give me $50 today or I'll have a truck at your door in the morning and take everything out of your house.") Lois Wood, Land of Lincoln Legal Assistance Foundation, R-I(c)-19; Martha Eller, Puget Sound Legal Assistance, Tr. 6638 ("the sheriff will come with us tonight to get the goods.").

[56] *E.g.*, Clare Rollwagen, Minnesota Consumer Finance Conference, Tr. 3962; Clarence Bleser, Wisconsin Finance Corporation, Tr. 3478; Don Pratt, Hometown Finance Company, Tr. 3103; Kenneth Davis, Kentucky Finance Company, Tr. 1547.

[57] *E.g.*, Martha Eller, Puget Sound Legal Assistance Foundation, Tr. 6638-40; Drew Johnson, Lane County Legal Aid Services, Inc., Tr. 6314-17; Mary Ellen Sloan, Utah Legal Services, Inc., Tr. 7344-45; Land of Lincoln Legal Assistance Foundation, R-I(c)-19, Case Histories A-C; Legal Aid Society of Metropolitan Denver, R-I(c)-45, Case History: Mildred F. and Laurie F; Bexar County Legal Aid Association, R-I(c)-78 at 2; Robert

This record demonstrates that such threats are made frequently, and that they are harmful in themselves. In recommending that household goods security interests be prohibited, the National Commission on Consumer Finance (NCCF), based on its comprehensive survey of the credit industry, found as follows:

> *A creditor should not be allowed to take other than a purchase money security interest in household goods.*
>
> A creditor should be able to take a security interest in goods which form the basis of the transaction, but security interests in household goods should not be allowed in any loan or consolidation transaction if the goods were not acquired by the use of that credit. In the event of default, such security interest in household goods and the accompanying right to repossess or threat to repossess such goods have far too disruptive an impact on the family life of the debtor to be in the public interest.[58]

Our view of the record supports our similar finding on the disruptive and harmful impact of threats to seize household goods. Because the economic loss to the consumer inherent in the seizure of household goods is so large, the threat to seize is correspondingly substantial. Legal services witnesses and others who appeared and commented in the proceeding offered first-hand experience of the harmful impact of creditor threats to seize furniture and personal possessions.[59]

H. Gage, Legal Aid Society of Mecklenburg County, HX-44, Case History: Glenda Josephs.

[58] *Consumer Credit in the United States*, Report of the NCCF at 27 (1972).

[59] *E.g.*, Tucker Trautman, Colorado Department of Law, Tr. 6477; John F. Robert, Louisiana Consumers League, Tr. 1970; George Wallace, University of Iowa Law School, Tr. 11889; Roberty Lohert, Chapter 13 Trustee (retired), Tr. 5743; Martha Eller, Puget Sound Legal Assistance, Tr. 6638; Robert Gage, Legal Aid of Mecklenburg County, Tr. 1256; Kathleen Keest, Black Hawk County Legal Aid, Tr. 4293; Lawrence Mealer, Dallas Legal Services, Tr. 371.

However, the psychological impact of such threats does not define or exhaust the injury they occasion. It is important to acknowledge, as a general proposition, the position in which consumers find themselves when creditors have a lien on personal possessions. Debtors who are in default and on the verge of having their personal possessions seized are under considerable pressure to make repayment arrangements acceptable to the lender who is threatening repossession. To avoid the greater loss of repossessoin, such consumers are likely willing to take other steps they would not willingly take but for the security interest. Accordingly, such creditors are in a prime position to urge debtors to take steps which may worsen their financial circumstances.

Such steps may include agreements to refinance debts, and diversion of funds needed for other obligations to pay the creditor holding the security interest. Because of the perceived imminency of repossession, debtors may also forego the assertion of valid or meritorious defenses in their rush to complete acceptable repayment agreements.

Actions such as these are not necessarily harmful in and of themselves, nor are they harmful to consumers in all instances. In other situations, the Commission believes consumers will take such actions only if they are in the consumer's self-interest. Faced with the greater loss of a threatened repossession, however, consumers will willingly take steps that avoid immediate repossession, but otherwise worsen the consumer's situation. Faced with a security interest in HHG, consumers may endure lesser injuries to avoid the greater injury of repossession. Because of the security interest, these injuries cannot reasonably be avoided.

The rulemaking record reflects the fact that threats to seize household goods frequently accompany efforts to compel debtors to agree to refinancings of overdue obligations.[60] A refinancing [7765]

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[60] *E.g.*, R-XI-DIAL-208; Martha Eller, Puget Sound Legal Assistance, Tr. 6642; John Paer, Legal Aid of Hawaii, Tr. 5344; James Boyle, Texas

may reduce or defer scheduled monthly payments, but it does so by increasing the overall amount a debtor owes. Although refinancing is appropriate in some instances, it is against the debtor's economic interest in others.[61]

Threats to enforce HHG provisions can also lead to payment of the secured creditor's loan in preference to other, perhaps more immediate needs or obligations.[62] Fear that creditors will make good their threats to seize personal possessions if debtors do not promptly enter into new repayment agreements may also lead consumers to withhold assertion of legitimate counterclaims or set-offs.[63]

In the Commission's opinion, the use of blanket security interests to exhort an overextended or unemployed consumer to make a decision which may lead to increased financial difficulties has many of the attributes of economic duress.[64]

Consumer Protection Association, Tr. 28; Gerald Cope, Trustee, Chapter 13, Southern District of Maine, Tr. 10528, 10545; Kathleen Keest, Black Hawk County Legal Aid, Tr. 4260; Thomas Baltus Legal Services of Eastern Michigan, Tr. 3067; James L. Brown, Center for Consumer Affairs, University of Wisconsin, HX-153 at 5; Eugene Thiroif, Land of Lincoln Legal Assistance Foundation, Tr. 3364; Carl Woxman, North Carolina Consumer Finance Association, Tr. 10256-257.

[61] *Id. See also, e.g.*, Drew Johnson, Lane County Legal Aid, Tr. 6346-47; Lois Wood, Land of Lincoln Legal Assistance Foundation, R-I(c)-19; Terrance Terauchi, San Mateo Legal Aid, Tr. 7966; Kenneth Levin, Atlanta Legal Aid Society, HX-336 at 11; David Duhon, North Louisiana Legal Assistance, Tr. 1480-J; Stephen Hewitt, Lane County Legal Aid, R-II(f)-281; James Kocher, Lane County Legal Aid, Tr. 6377.

[62] *See, e.g.*, Stephen Hewitt, Lane County Legal Aid, R-II(f)-281 (debtors will give up food and clothing to keep household necessities).

[63] James Boyle, Texas Consumer Association, Tr. 28; John Paer, Legal Aid of Hawaii, Tr. 5344; Allison Steiner, Central Mississippi Legal Services, Tr. 1780; Charles DuMars, New Mexico Law School, Tr. 472.

[64] In this connection, the common law has long recognized that agreements should be set aside where a weaker party acquiesces to a contract in the face of a threatened wrong. Such a contract has no effect because the assent of the weaker party is coerced. *Goldstein* v. *Enoch*, 248 Cal. App. 2d 891, 57 Cal. Rptr. 19 (1967); *Sun Maid Raisin Growers* v. *Papazion*, 74 Cal. App. 231, 240 (1925).

Threats to seize the personal possessions of a consumer and his or her family clearly meet many of the criteria for economic duress, especially given the dire financial circumstances in which the consumer finds himself.[65] Although the Commission has premised its findings regarding the unfairness of threats to seize household goods on the resulting psychological and economic injury to consumers, as demonstrated by information contained in the rulemaking record, these common law doctrines provide evidence of public policy supporting the Commission's findings.

Since default most frequently occurs for reasons that are not within the control of the debtor,[66] the threat to seize household possessions causes "great emotional suffering, humiliation, anxiety, and deep feelings of guilt, and this distress can lead to physical breakdowns or illness, disruption of the family, and undue strain on family relationships."[67]

For these reasons, the Commission concludes that non-purchase money security interests in household goods cause substantial consumer injury.

D. Offsetting Benefits

Although the industry acknowledged that household goods generally have limited value and expressed disapproval of threats and harassment associated with their use, the industry maintained that blanket security interests were essential.

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[65] *People ex rel. Buell* v. *Buell*, 20 Ill. App. 2d 82; 155 N.E.2d 104 (1959); *Nixon* v. *Leitman*, 32 Misc. 2d 461; 224 N.Y.S. 2d 448 (1962). The use of unequal bargaining power to force a person in an unusually distressing situation to agree to harsh contract terms has been held to constitute duress at common law. *Oswald* v. *City of El Centro*, 211 Cal. 45, 292 P. 1073 (1930). Undue influence has been defined as the "taking of grossly oppressive and unfair advantage of another's necessity and distress." Cal. Civ. Code 1575. *See also Campbell Soup* v. *Wentz*, 172 F.2d 80, 82 (3d Cir. 1949).

[66] *See supra* Chapter III.

[67] Presiding Officer's Report at 136, *citing* Martha Eller, Puget Sound Legal Assistance, Tr. 6640-42.

"This is the edge" that makes the debtor pay.[68] Creditors stated that borrowers are much better disciplined if they pledge their household goods[69] and that the psychological value is essential.[70] Such security interests were felt to enhance a debtor's sense of moral obligation[71] and to encourage prompt payment. [72] It was further argued that the security interest in household goods is evidence of a debtor's good faith effort to repay.[73] In addition, it was stated that many consumers have nothing else to offer as security.[74] Overall, the industry argued that in the absence of household goods security interests costs would increase and debtors will not obtain credit.[75] It should be noted, however, that according to a survey of legal aid attorneys, their experience with legal aid clients indicated that 40 percent of finance company loans containing security interests (principally but not only in household goods) were for home improvements, suggesting that the borrowers were homeowners and therefore may have had other assets to pledge as security.[76]

It was maintained that low-income consumers who have the most problems with collection practices would be denied credit in the event that blanket security interests could not be

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[68] James White, Council of State Credit Institutes, HX-461.

[69] *E.g.*, Alan Susman, West Virginia State Senate, Owner of small loan company, Tr. 4878; George Prentiss, Citizens Budget Co., Tr. 4230-31.

[70] *E.g.*, Robert Abrahams, Walter E. Heller Company, Tr. 979[illegible] Kenneth Davis, Kentucky Finance Co., Tr. 1528.

[71] *E.g.*, Lester Sodowick, New Jersey Consumer Finance Association, Tr. 8392.

[72] *E.g.*, Alabama Lenders Association, R-I(a)-361.

[73] *E.g.*, Richard Van Winkle, Utah Consumer Finance Association, Tr. 7607; Al Brandt, Brandt Finance Company, Tr. 7521; William Martin, Oregon Consumer Finance Association, Tr. 7563; Stephen Hellerstein, Colorado Industrial Bankers Association, Tr. 7107-08.

[74] *E.g.*, David Wood, Dial Financial Corp., R-I(a)-172; Helmut Schmidt, Transamerica Financial Corporation, Tr. 6190.

[75] *E.g.*, Creighton Lynch, Tr. 1859. *See also* Summary of Post-Record Comments XV-357 at 66, notes 36-38.

[76] NCLC survey, *supra* note 46 at 27.

taken.[77] Individual finance company operators stated that many loans would not be made absent household goods liens.[78] One finance company officer estimated that for his company the charge-off rate for unsecured loans is nearly two-thirds higher than for secured loans, and concluded that "if security was forbidden" and a similar charge-off rate applied to all accounts, bad debt losses would mount and credit restriction would result.[79] Certain industry witnesses considered threats to seize household goods to be a valuable remedy.

> Q. What is there about security interests in household goods that seems to qualify an otherwise marginal debtor for credit?
>
> A. Well, there are several things. First of all, I do believe and have experience that household goods do provide some monetary security * * *
>
> Number two, there is a psychological disadvantage to the consumer, in a sense (I hate to use the word "disadvantage"), in fact that we eventually back that truck up, tote his stuff out. His neighbors see it; his friends see it. It is embarassing. It shows up on his credit record as a repossession. Man, next to a charge-off, that about as bad as you can do.[80]

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[77] *E.g.*, Prepared Statement of Robert P. Shay on behalf of the National Consumer Finance Association, HX-494 at 43, 45.

[78] *E.g.*, John Mosley, Mosley Finance Company, Tr. 910; Lester Sodowick, New Jersey Consumer Finance Association, Tr. 8392-93; Burton Caine, Pennsylvania Consumer Finance Association, Tr. 8430; Richard Van Winkle, Lockhart Company, Tr. 7607-08.

[79] William E. Wehner, Household Finance Corp., Tr. 9089. Mr. Wehner acknowledged that recoveries are made on charged-off accounts in some cases. Tr. 9104-05.

[80] John Mosley, Mosley Finance Company, Tr. 945.

The industry thus maintained, to a varying extent, that the household goods security interest was "a difference between in and out of this business."[81] **[7766]**

The rule provision we here adopt meets many of the objections of industry by incorporating substantial modifications (discussed in Section G, below) to the original, more sweeping 1975 proposal which was the prime focus of industry testimony and comment. By enacting a provision which leaves purchase money loans untouched and permits consumers to pledge many valuable possessions as security, we believe the rule meets most of the industry apprehensions that this provision would act to "forbid" security.

Moreover, although the consumer finance industry generally took the position that blanket security interests are essential, individual firms from different states testified as to their capacity to operate successfully without such security. In some cases, firms operated in states which prohibit the household goods secured loan.[82] In other cases, some creditors simply decided not to avail themselves of a blanket security interest, and indicated that they did not perceive any major

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[81] Helmut Schmidt, Transamerica Financial Corporation, Tr. 6214. *See also*, Summary of Post-Record Comments HX-357 at 72-73, nn. 70-72. The Presiding Officer further found that "the loss of this right would undoubtedly have very considerable impact on their (creditors') operations and upon the availability of credit to consumers." *Id.* We consider that this finding is not supported by the preponderance of record evidence, given the substantial narrowing of the scope of the HHG provision we enact today, as compared to the 1975 proposal addressed by the Presiding Officer. The Presiding Officer also based his conclusion in part on a finding that HHG security interests had "usefulness * * * in causing the consumer to reaffirm a debt following bankruptcy." Presiding Officer's Report at 311. Given the changes to the Bankruptcy Code under the Bankruptcy Reform Act of 1978 (after the Presiding Officer's findings), this benefit to creditors would be substantially eroded, if not eliminated entirely.

[82] *E.g.*, Bernard Cunningham, Windsor Locks Finance Company, Connecticut, Tr. 8559, *et. seq.* Connecticut prohibits household goods security interests in consumer loans. *See supra* note 10.

increase in delinquency or collection problems.[83] Non-consumer finance company creditors testified to their lack of confidence in household goods security interests.[84]

To evaluate the argument that a prohibition of household goods security interests would result in increased default and delinquency and/or a foreclosure of "high risk" consumers from the credit market, the rulemaking staff analyzed data furnished by the National Consumer Finance Association (NCFA).[85] NCFA data on secured and unsecured borrowers reveal no significant difference between the income levels of such borrowers and no significant difference between the level of indebtedness of such borrowers at the time credit was extended.[86] It is important to remember that the rule does not

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[83] *E.g.*, William Lehye, Consumer Loan Company, Tr. 4367, *et seq.*; Fernando Negron, Island Finance Company, Tr. 8639. In these cases, however, there is no evidence that the creditor publicized or otherwise made known the determination not to employ HHG security interests. This is consistent with record evidence showing that, even where differences exist between creditors in the remedies they employ, consumers cannot reasonably differentiate between creditors for purposes of comparing or shopping for different contract remedy terms.

[84] *E.g.*, William Gwennapp, American Bankers Association, Tr. 12200; John Montgomery, Illinois Bankers Association, Tr. 2581; Michael Milroy, Valley National Bank of Arizona, Tr. 5469; Joe Martin, First United Bancorporation, Tr. 1156; Robert Tobey, Consumer Bankers Association, R-1(a)-466; Betty Gregg, Credit Union National Association, Tr. 9690-01; Joan Morton, California Credit Union League, Tr. 7185; G.R. Slater, Harris Bank, R-II(f)-132.

[85] R-XIII-3; R-XIII-37.

[86] For a discussion of staff's methodology and analysis, *see* Staff Report at 233-35; R-XIII-3, Tables 1-4 and accompanying discussion. These data also show a higher average loan amount for secured loans versus unsecured loans. The data confirm that, where HHG security interests are permissible, creditors feel more secure taking such collateral; they do not tell us what happens when HHG security interests are restricted. Comparing data for HHG-restrictive states (Connecticut, Wisconsin, Iowa) with non-restrictive states suggests that creditors do not significantly restrict credit availability in response to curtailment in the availability of blanket HHG security interest. *Id.*

prohibit purchase money security interests or security interests in other than household goods, as defined.

Additionally, the testimony of several state regulators representing states which restrict blanket security interests bears out the statistical evidence that state regulatory schemes that include a restriction on creditors' ability to take blanket security interests in household goods do not have adverse effects on credit cost or availability. Specifically, Thomas Huston, Superintendent of Banking, State of Iowa, testified that the Iowa U.C.C.C. (which, among other provisions, restricts the scope of HHG security interests) had no effect on credit extensions in his state.[87]

From a creditor's standpoint, the facts about the causes of consumer default in credit obligations suggest that the benefits of blanket security interests as a collection device are limited. Given that the majority of defaults occur for reasons beyond the borrower's control,[88] a threat to seize furniture and personal possessions is of marginal value in cases of serious delinquency. Unemployed debtors, or debtors with sudden and substantial emergency expenses are hardly more able to remit monthly payments because they receive a threat to seize the furniture.

E. The California Situation

A special problem was raised by industry witnesses in the State of California. It was argued that the prohibition on blanket security interests in household goods would make it impossible for the consumer finance industry to remain in business, because legal interest rates are tied to the taking of

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[87] Tr. 2285; *see also* HX-29 at 3 for a similar assessment by the Iowa Attorney General. Mr. Huston recommended an HHG provision which excepts "luxury items" Tr. 2285-86.

[88] *See* discussion *supra* Chapter III; Presiding Officer's Report at 44-52.

security.[89] The industry maintained that the proposed rule would make it impossible for finance companies to lend under the Personal Property Broker's Law.[90]

The industry maintained that prohibiting security interests in household goods and prohibiting wage assignments would amount to a prohibition against small loan companies doing business in California because the applicable statute defines such lenders as those who take such security and/or wage assignments.

We find that the apprehension expressed by the California finance industry is unwarranted. The record indicates that, in practice, any personal property of any kind will suffice as security for the purpose of the statute.[91] Lenders comply with the California law by taking a nominal security interest in a fountain pen or a ring.[92] They can continue to take similar nominal security interests under the rule we promulgate here.[93] The rule does not require any changes in California

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[89] *See generally*, testimony of Earle Nelson, California Department of Corporations, Tr. 5008; George Richter, California Loan and Finance Association, Tr. 5865. California, Consumer Finance Association, Post-Record Comments XV-338, at 16-18.

[90] George Richter, California Loan and Finance Association, Tr. 5862. *See also* Staff Report at 238, note 128.

[91] "A close examination of these two forms of security will quickly show that they are largely a fiction device to permit this category of lender to function outside the 10 percent interest limitation." Mervyn Dymally, Lieutenant Governor of California, Tr. 6514.

[92] Earle Nelson, California Department of Corporations, Tr. 5043, 5044-46; George Richter, California Loan and Finance Association, Tr. 5909.

[93] Wage assignments in California, which also qualify a lender as a personal property broker, may only apply to income already earned at the time credit is extended. Such wage assignments are not prohibited by the rule.

Moreover, the rule does not prohibit all security interests in personal property. Purchase money security interests in such property are permitted, as are non-purchase money security interests in other than household goods, as defined, such as jewelry. Finally, there are other statutory alternatives in existence in California, which permit lenders to charge rates in excess of the constitutional usury limitation, and which consumer finance

statutory law to permit consumer finance companies to remain in business. [7767]

F. Conclusion

Evidence of record establishes that non-purchase money security interests in household goods are the products of contracts the terms of which consumers cannot reasonably avoid, and that their use occasions substantial injury. We further conclude, based on the evidence, that such security interests produce injury which is not outweighed by countervailing benefits to consumers or competition. Based on the preponderance of evidence in this record, the Commission therefore finds that the use of non-purchase money security interests in consumer transactions is an unfair practice.

Although the capacity to disrupt the home of a consumer and his or her family has some value to a creditor, the practice elicits minimal benefits in return for substantial injury. This is why the NCCF recommended abolition of non-purchase money security interests in household goods.[94]

The Presiding Officer found that "a grant of a non-purchase money security in household goods has the potential and will, in many cases, result in injury far greater than any benefits to be gained through the use of the credit thereby obtained."[95] We concur.

Finally, this provision has been substantially revised to narrow its scope and increase its clarity. This provision responds to the major concerns raised by the industry and discussed by the Presiding Officer. As revised, the rule will prevent the use of non-purchase money security interests in those household goods that the record demonstrates have

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companies use. An example is the Industrial Loan Law under which finance companies may operate that affords a rate structure that is slightly lower than that under the Personal Property Brokers Law. *See e.g.*, Earle Nelson, California Department of Corporations, Tr. 5043.

[94] *See supra* note 58.

[95] Presiding Officer's Report at 162.

little economic value to creditors. The revised rule will not affect other kinds of security interests, nor will it prevent the use of purchase money security interests in household goods.

G. Alternatives considered and modifications adopted

In the course of proceedings on the rule several problems with the text of proposed section (a)(4) became apparent. Accordingly, the provision we now adopt contains modifications consistent with the information developed.

As proposed, Section (a)(4) would have restricted creditors to a purchase money security interest in the event that the credit extended was used to purchase consumer goods. No other property could be used to secure the extension of credit. Thus, an automobile loan could not be secured by a second mortgage on real estate or by any collateral other than the automobile itself. The industry maintained that this approach was too restrictive, especially in the second mortgage area, and the rulemaking staff concurred.[96] The purpose of this rule is to prevent the use of non-purchase money security interests in those household goods which constitute necessities and not to prevent consumers from borrowing on the equity in their homes, stocks and bonds, etc., or pledging certain valuable assets if they choose to. The language of the provision we adopt eliminates non-purchase money security interests in household goods (as defined) while permitting consumers to agree to second mortgages where it is in their interest to do so. It permits the use of non-household goods collateral, in any appropriate credit transaction, but limits household goods security interests to transactions where the credit received was applied to their acquisition.

In reviewing this rule provision the staff noted an ambiguity as to whether the rule applied to possessory security interests, *i.e.*, property held in the possession of the secured party such as a pawnbroker. Under the U.C.C. pawns and pledges are "security interests" but were not intended to be covered

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[96] Staff Report at 24-5, note 140.

by the rule. Thus Section a(4) has been revised to make it clear that it only applies to non-possessory security interests. This will eliminate any uncertainty as to whether a consumer can pawn or pledge household items. The record furnishes no evidence that such possessory security interests cause any injury.

The rule does not apply to purchase money security interests. When a purchase money loan is refinanced or consolidated, we intend that, for purposes of this rule, the security collateralizing the prior loan can continue to secure the new loan, even if the new loan is for a larger amount or is in other respects a non-purchase money loan. In enunciating our intent for purposes of this rule, we intimate no opinion with respect to different approaches taken by various jurisdictions in analogous questions raised under the Bankruptcy Code.[97]

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[97] The issue arises in the context of bankruptcy proceedings because the 1978 bankruptcy reforms provided an exception to the old rule that secured loans survived bankruptcy, for those loans secured by blanket security interests in household goods. 11 U.S.C. 522(f)(2)(A). This has resulted in litigation over the question of whether consolidated or refinanced loans, secured in part by previous purchase money collateral, can be avoided in bankruptcy, *i.e.*, whether they are purchase money loans or HHG-secured loans. Different courts have reached different results. *Compare, e.g., In re Manuel*, 507 F.2d 990 (5th Cir. 1975) *with In re Conn*, 16 B.R. 454 (Bkrtcy., W.D. Ky. 1962) and *In re Russell*, 29 B.R. 270 (Bkrtcy., W.D. Okla. 1983). We intend that, for purposes of this rule, when a loan is consolidated or refinanced, a creditor can retain an existing purchase money security interest in collateral which would otherwise come within the rule's definition of household goods. Thus, analogous "transformation" rules in bankruptcy decisions will have no bearing in determining, for purposes of the rule, the basic character of the collateral at the time of the refinancing or consolidation.

Those jurisdictions that do not follow the automatic transformation rule generally adopt a method of determining the extent of the purchase money interest in the refinanced loan: most often some variant on the first-in; first-out payment method specified in the U.C.C.C. section 2-408. To the extent that this issue arises with respect to our rule, state law should govern the determination of the extent of the security interest. For purposes of determining compliance with the rule, however, we intend that courts should look to the validity of the contract under the rule at the time the contract is signed. Thus, if under applicable state law an interest is in part a

We adopt a further modification to this section of the rule narrowing the definition of "household goods" to more nearly limit coverage to necessities and to permit the pledge of certain possessions which have significant economic value. This modification has been undertaken in response to comment [98] and to narrow the prohibition to the class of goods for which the injury to consumers from a security interest exceeds offsetting benefits.

Specifically, we define "household goods" in terms of a list of common household necessities, together with some items of uniquely personal value, excluding these categories:

(1) Works of art;

(2) Electronic entertainment equipment (except for one television and one radio);

(3) Items acquired as antiques; and

(4) Jewelry (except wedding rings).

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purchase money security interest at the time a contract is signed, the contract does not violate the rule, even if the purchase money portion of the interest is exhausted before the end of the contract.

[98] *E.g.*, Thomas Huston, Superintendent of Banking, Iowa, Tr. 2285-86; W.C. Evans, Texas Finance Association, Tr. 960; Clarence Bleser, Wisconsin Finance Corporation, Tr. 3467 ("luxury household goods"), 3472 ("boats, snowmobiles, television sets, pianos"); Harold T. Welsh, Illinois Credit Union League, Tr. 4098-99 (piano); Robert Mallock, Beneficial Management Corporation, Tr. 9577 ("multiple TV's, stereos, home workshops * * * "); Betty Gregg, Credit Union National Association, Inc., Tr. 9665 (jewelry). *See also* Post-Record Comments XV-338 at 56 (finance company); XV-274 (credit union concerned about jewelry); XV-123 (credit union—should exclude things held for investment); XV-213 (credit union—piano "could retain most of its value for the term of a five year loan while a room full of furniture depreciated to next to nothing").

We define "antique" as

> Any item over one hundred years of age, including such articles which have been [7768] repaired or renovated without changing their original form or character. (§ 444.1(j))[99]

"Personal effects" is not defined in the rule; we intend it to have its commonly accepted meaning as "Articles associated with a person, as property having more or less intimate relation to the person of the possessor * * * ." [100] We specifically include wedding rings within the term "personal effects". Other items clearly within the ambit of the term include those which an individual would ordinarily carry about on his or her person and possessions of uniquely personal nature, such as family photographs. Thus, the definition of household goods does not cover items such as boats, snowmobiles, cameras and camera equipment (including darkroom equipment), pianos, multiple television sets, home workshops and the like.[101]

We exclude one television and one radio from the term "electronic entertainment equipment" because, in contemporary society, these items have become virtual necessities. For families in rural or isolated areas, a radio is an absolute necessity. For many—especially disabled or infirm persons, or shut-ins—a television may be an equal necessity. We intend that the term "radio" apply to a conventional, self-contained unit (such as a table model radio, or a transistorized portable

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[99] The definition is suggested by U.S. Customs description (Tariff Schedules of the United States Annotated (1976) at 52, Schedule 7, Part II, Subparagraph B 766.20).

[100] *Black's Law Dictionary*, at 1301 (4th ed. 1951). *See also Roberts* v. *U.S.*, 332 F.2d 892, 898 (8th Cir. 1964).

[101] *See supra* note 98. In so defining the term "household goods", the Commission makes no value judgment as to what items constitute "luxuries". We have simply sought to identify, as nearly as practicable, a list of common items which would, in contemporary society, be agreed to constitute necessities. Conversely, we have, in response to record testimony and comment, identified a specific list of exceptions—not necessarily "luxury" items—which are likely to have significant resale value (as most used household goods do not) and in which creditors may still take a security interest.

radio) with its primary function as a radio. The term does not encompass multi-component audio systems, even though one element of such a system is a radio receiver. Nor does it apply to portable, self-contained, multi-function units (tape recorder/player, amplifier, clock), only one element of which is a radio receiver.

We have provided that wedding rings be included within the term "household goods." This permits consumers to pledge as collateral for non-purchase money loans any items of jewelry, with the exception only of wedding rings, which should be protected because of their unique psychological and emotional value.[102]

To the extent that individual states provide protections substantially equivalent to, or more protective than, this rule provision but do so by specifying a definition of "household goods" that differs in content from that employed in the rule, the exemption provision of the rule (§ 444.5) is available to allow any such state to petition for exemption.

VII. Waivers of Exemption

Section 444.2(a)(2) of the Rule provides that it is an unfair act or practice for a lender or retail installment seller to take or receive from a consumer an obligation that constitutes or contains a waiver or limit of exemption from attachment, execution or other process on real or personal property held, owned by, or due to the consumer.

A. State Law

At common law, all property of a judgment debtor was subject to execution in order to satisfy the judgment debt. Beginning in the nineteenth century, however, most states and the District of Columbia enacted laws that exempted certain property from judicial seizure and sale. The property

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[102] *See Bingham* v. *Collection Bureau, Inc.*, 505 F. Supp. 894, 873-74 (D.N.D. 1981).

exempted usually consisted of a homestead and other necessary items, such as furniture, clothing, family Bible, tools of the trade, animals used in farming, etc. Today, many states retain laws containing lists of exempt personalty, while others simply exempt personalty up to a specified amount. Several current statutes combine aspects of both approaches.[1]

The basic reason for exemption laws is to afford minimal protection to debtors and their families by allowing them to retain the prime necessities of life, with a view to preserving the family unit and furnishing the insolvent with nucleus to begin life anew.[2]

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[1] Alabama, for example, exempts $1,000 of personalty, (Ala. Const. Art. 10, section 204 (1901), burial plots, church pews, wearing apparel, family portraits, books, and a homestead of up to 160 acres and $2,000 in value. (Ala. Code Tit. 7, sections 625, 628 & 629). North Dakota's homestead exemption has a ceiling of $40,000. (N.D. Cent. Code section 47-18-01 (Supp. 1973)). Texas, in its personal property exemption, includes 5 cows, 1 bull, 20 hogs, 20 goats, 50 chickens, 30 turkeys, 30 ducks, 30 geese, 30 guineas, farming implements, tools, and athletic equipment and other items up to $30,000 for a family. (Tex. Rev. Stat. Ann. Art. 3832 (1935)). Among other items, Pennsylvania exempts leased pianos, melodeons and organs, loaned, leased or conditionally sold ice cream cabinets, and articles on display at a nineteenth century international exhibition in Philadelphia. (Pa. Stat. Ann. Tit. 12, sections 2170, 2172 & 2174 (1876)). Wide variations in the coverage of state exemption statutes precipitated, in part, the federal enactment of a uniform property exemption in bankruptcy proceedings. 11 U.S.C. 522(d).

A few states and the District of Columbia apparently have no homestead exemptions (*e.g.*, Connecticut, Delaware, Indiana, New Jersey, Pennsylvania, Rhode Island), NCFA Comments, XV-343 at A-9. All states which have homestead exemptions also provide for the waiver of such exemptions when the exempt property is given as security for a loan. *See, e.g.*, XV-343 at A-7-9.

[2] *See* Presiding Officer's Report at 98 notes 1 and 3 citing Vukowich, *Debtor's Exemption Rights*, 62 Geo. L.J. 779, at 782-88 (1974); *Mayhugh* v. *Coon*, 460 Pa. 128, 331 A.2d 452 (1975). In this respect, these laws parallel one of the basic purposes of the bankruptcy laws, allowing debtors and their families to retain property sufficient for a "fresh start" following a financial setback.

Under general principles of contract law, it has been considered that the right to claim an exemption is a personal right to be claimed or waived at the discretion of the debtor,[3] unless state law specifically prohibits such waiver. In a number of states, there appears to be no such legal impediment to waiver of statutory exemptions of personalty.[4] A number of jurisdictions prohibit waivers of exemption based on the strong public interest in protecting improvement debtors and their families.[5] **[7769]**

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[3] *See, e.g., Parsons* v. *Evans*, 44 Okla. 751, 145 P. 1122 (1915).

[4] *E.g.*, Hawaii, Idaho, New Hampshire, New Jersey, New Mexico, Rhode Island, South Carolina, Texas, Vermont. The NCFA survey found, however, that only six states—Alabama, Georgia, Kentucky, Louisiana, Maryland and Virginia—allow the homestead exemption to be waived by an executory clause without specifically taking a security interest. R-XIII-31 at C-9.

[5] *See, e.g., Mealey* v. *Martin*, 468 P.2d 965 (Alaska 1970); *Lindsay* v. *Merrill*, 36 Ark. 545 (1880); *Industrial Loan & Investment Co. of San Francisco* v. *Superior Court*, 189 Calif. 546, 209 P. 360(1922); *Weaver* v. *Lynch*, 79 Colo. 537, 246 P. 789 (1926); *Wallingsford* v. *Bennett*, 12 D.C. (1 Mackey) 303 (1881); *Sherbill* v. *Miller Mfg. Co.*, 89 So. 2d 28 (Fla. 1956); *Carter's Administrators* v. *Carter*, 20 Fla. 558 (1884); *Maloney* v. *Newton*, 85 Ind. 565, (1882); *Curtis* v. *O'Brien*, 20 Iowa 376, (1886); *Iowa Mutual Ins. Co.* v. *Parr*, 189 Kan. 475, 370 P.2d 400 (1962); *Moxley* v. *Regan*, 73 Ky. 156, (1873); *Oxford* v. *Colvin*, 134 La. 1094, 64 So. 919 (1914); *Maxwell* v. *Roach*, 106 La. 123 (1901); *Benning* v. *Hessler*, 144 Minn. 403, 175 N.W. 682 (1920); *Teague* v. *Weeks*, 89 Miss. 360, 42 So. 172 (1906); *Meyer Bros. Drug Co.* v. *Bybee*, 179 Mo. 354, 78 S.W. 579 (1904); *Anaconda Federal Credit Union #4401* v. *West*, 157 Mont. 175, 483 P.2d 909 (1971); *Kneetle* v. *Newcomb*, 22 N.Y. 249, (1860); *Dennis* v. *Smith*, 125 Ohio St. 120, 180 N.E. 638 (1932); *Mayhugh* v. *Coon*, 480 Pa. 128, 331, A.2d 452 (1975); *Longley* v. *Daly*, 1 S.D. 257, 46 N.W. 247 (1890); *Mills* v. *Bennett*, 94 Tenn. 651, 30 S.W. 748 (1895); *Bunker* v. *Coons*, 21 Utah 164, 60 P. 549 (1900); *Slyfield* v. *Willard*, 43 Wash. 179, 86 P. 392 (1906); *Maxwell* v. *Reed*, 7 Wis. 493 (1859). Two courts, in dicta, have stated executory waivers are invalid. *Farmers & Merchant's Bank of Sterling* v. *Hoffman*, 5 Neb. 9, 96 N.W. 1044 (1906); and *Delfelder* v. *Teton Land & Inv. Co.*, 46 Wyo. 142, 24 P.2d 702, *reh'g. denied*, 46 Wyo. 200, 26 P.2d 153, (1933) (dicta that executory waivers are invalid). *See also* Ariz. Rev. Stat. Ann. section 33-1122 (Supp. 1983-1984) (exemptions do not apply to property used as a security interest or a pledge); Ga. Code Ann. section 51-1101 (1979 & Supp. 1982); Ill. Stat. Ann. ch. 110, section 12-904 (Smith-Hurd Supp. 1983); Ky. Rev. Stat. section 427.100 (1970 & Supp. 1982); La. Rev. Stat. Ann. sections 20:1, :32 (West

In most states, the homestead exemption that protects real property may be waived by granting a specific interest in the property by way of a mortgage. The Uniform Consumer Credit Code, as well as the laws of some of the other states, however, prohibits the taking of a security interest in real property as security for loans below a stated amount and by certain types of lenders.[6]

Non-purchase money waivers of personal property exemptions are treated more stringently by the states, particularly where the personal property consists of necessary household goods. Some states prohibit the taking of non-purchase money security interests in all[7] or listed[8] personal property that is the subject of exemptions. In those states where general executory waivers of exemption are prohibited, it is generally done on the basis of the legislative intent in creating exemptions, that is, to protect the debtor

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1979 & Supp. 1983); Md. Com. Law Code Ann. section 11-504 (Supp. 1983); Md. Cts. & Jud. Proc. section 15-802 (1983); N.D. Cent. Code section 28-22-02 (Supp. 1982); Or. Rev. Stat. sections 23.164,.220 (1979); S.C. Code Ann. sections 51-41-120, 15-41-310 (1976); S.D. Comp. Laws Ann. section 44-8-7 (1967 and Supp. 1982) (identifying "absolutely" exempt items not subject to waiver); Va. Code section 34-22 (1976) (waiver of personalty exemption void); W. Va. Code section 38-8-15 (Supp. 1983).

[6] Under U.C.C.C. Section 2.307 supervised lenders may not accept land as security for a loan in which the amount financed is $1,000 or less. Under Section 3.301 of the U.C.C.C., in a consumer credit sale, a security interest may be taken in land to which the goods are affixed or which is maintained, repaired, or improved as a result of the sale of the goods or services if the debt is $1,000 or less. In some states small loan licensees may not take a security interest in land at all. *See, e.g.*, Kenneth C. Davis, Kentucky Consumer Finance Association, Tr. 1527; the same is true in Alabama, (HX-5 at 12. *See also* Gordon J. Thomasch, Maryland Consumer Finance Association, Tr. 8916.)

[7] *E.g.*, Conn. Gen. Stat. Ann. section 36-236 (West 1981).

[8] *E.g.*, Iowa Code Ann. section 537.3301 (West Supp. 1983-1984); Wis. Stat. Ann. section 422.417 (West 1957 & Supp. 1983-1984).

and the debtor's family from thoughtlessness, extravagance, and improvidence.[9]

State action regarding waivers of exemption reveals the costs and benefits associated with the practice and its restriction, as viewed by the various jurisdictions. The fact that a relatively large number of states have acted in this area is not, in itself, determinative of the unfairness of a practice. Rather, examining state action aids the Commission in identifying the relevant issues in its own assessment of the unfairness of waivers.

B. Prevalence

The rulemaking record establishes that creditors frequently include clauses in their consumer credit contracts that require consumers to waive statutory protections. Although the rulemaking record does not permit a precise determination as to the frequency with which creditors include waivers in consumer contracts, the preponderance of the evidence does support a finding that the use of general waivers of exemption is prevalent, even in jurisdictions in which such provisions would not be given effect.[10] This permits the use of such clauses as *in terrorem* collection devices,

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[9] *See, e.g., Indus. Loan & Inv. Co. of San Francisco* v. *Superior Court*, 189 Cal. 546, 209 P. 360 (1922); *Sherbill* v. *Miller Manufacturing Co.*, 89 So. 2d 28 (Fla. 1956); *Iowa Mutual Ins. Co.* v. *Parr*, 189 Kan. 475, 482, 370 P. 2d 400, 404 (1962); *Benning* v. *Hessler*, 144 Minn. 403,175 N.W. 682 (1920); *Mayhugh* v. *Coon*, 460 Pa. 128, 131, 331 A.2d 452, 455-56 (1975).

[10] Overall, the NCFA survey showed waivers appeared in roughly one-third of precomputed loan contracts and one-fourth of per diem loan contracts, including contracts in states where they are unenforceable. In West Virginia, waivers were used in 91 percent of cash loan contracts. Waivers appeared in at least 70 percent of such contracts in Alabama (81 percent), Vermont (80 percent), Georgia (77 percent), New York (75 percent), and Arizona (72 percent). HX-494 at 35. It is unclear whether these waivers are advance waivers prohibited by the rule of security interests styled as waivers. Presiding Officer's Report at 112. *See infra* Section E. For example, in Alabama, Arizona, and New York, which have declared blanket waivers void, over 70 percent of the contracts surveyed by NCFA for this proceeding

illustrating the gap in those states that may prohibit execution on waivers of exemption clauses, but not their inclusion in consumer credit contracts.

C. Consumer Injury

Waivers of state statutory exemptions permit creditors to seize, or threaten to seize,[11] possessions that, by statutory definition, are necessities. Although in contrast to security interests execution on exempt property requires court action, waivers are essentially an alternate means to the same end as non-purchase money security interests in household goods. Thus, the consumer injury is essentially the same as that noted above in our discussion of household goods security interests (Chapter VI).

The record shows that much exempt property has little economic value as collateral, but great economic, psychological, and sentimental value to consumers. Generally, waivers are coupled with a blanket security interest in household goods;[12] in other cases such a waiver, standing alone, is used to reach property that would be otherwise exempt.[13]

Because of its low economic value, exempt property is rarely seized.[14] The record, however, reflects indications of actual seizures.[15] The record also shows that threats of

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contained such waivers. *See* HX-494 at 35. *See also*, Kenneth Levin, Atlanta Legal Aid Society, HX-336.

[11] *See infra* note 16.

[12] *E.g.*, Philip A. Lehman, Legal Aid Society of Mecklenburg County, R-I(c)-77, Case History: Mack.

[13] *E.g.*, Daniel W. Molloy, Legal Aid Society of Mobile County, HX-72 at Exh. 5, (elderly home owner waived a homestead exemption in a $485 note to pay for a chain link fence) and Exh. 6. *See also*, Ken McDuffie, Georgia Legal Services Program, R-I(c)-84; Leonard Green, Wake County Legal Aid, R-I(c)-76, Case History II.

[14] *E.g.*, Karl Friedman, Alabama Consumer Finance Ass'n., Tr. 63; *see also* HX-467, at 32-33; Jonathan Epstein, Essex-Newark Legal Services, HX-376,Tr. 8948.

[15] John F. Robbert, Louisiana Consumer League, Tr. 1970; Richard F. Halliburton, Legal Aid of Kansas City, R-I(c)-102.

[footnote continued]

seizure, in the context of collection, are frequent.[16] The common inclusion of waivers of exemption clauses in consumer credit contracts, especially in jurisdictions where they are not enforceable, suggests their primary use as *in terrorem* collection devices.[17]

The record also shows that, in some instances, threats to seize exempt property force debtors to pay disputed debts or to waive legitimate claims or defenses that would otherwise reduce or eliminate their debts.[18] Such threats can also disrupt household finances, leading **[7770]** to delinquency on other obligations or resulting in costly refinancing.[19]

See also prepared statement of Robert P. Fickell, Supervisor of the Consumer Finance Section, Ohio Department of Commerce, HX-155. Mr. Fickell stated that in Ohio in 1976, "301 loans would have benefited" from this rule provision. (Although Mr. Fickell opposed the provision, his opposition was based, as was the opposition of other creditors, on a misapprehension that the provision would bar waiver of exemption rights through the grant of a security interest in otherwise exempt property at the time a loan is executed.)

[16] *See, e.g.*, Jonathan Epstein, Essex-Newark Legal Services, Tr. 8949; Herbert Beskin, Charlottesville-Albemarle Legal Aid Society, HX-377 at 5-6; John M. Sears, Rhode Island Legal Services, Tr. 9970. Although waivers of exemption are not given legal effect until the creditor reduces a claim to judgment, that technical reality does not necessarily stand in the way of creditors' *in terrorem* use of waivers. Such use is abetted by most consumers' unfamiliarity with the technicalities of the legal process in general and, specifically, their unawareness of the significance of waivers *(see supra* notes 10-11).

[17] Note 10, *supra*. *See also*, R-XIII-36 (NCFA state-by-state printout); post-record comment XV-226, Pentagon Federal Credit Union, Virginia ("It is a fear tactic and not normally enforceable.").

[18] *See* NCLC survey, HX-467 at 34, indicating that legal aid attorneys believe threatened use of waivers results in unreasonable settlement of claims at a 20-21 percent frequency. *See also*, Daniel Molloy, Mobile County Legal Aid, HX-72; Kenneth Levin, Atlanta Legal Aid society, HX-336 at 8.

[19] *See* NCLC survey, HX-467 at 34, showing legal aid attorneys believe delinquencies on other obligations occur 40 percent of the time, payments of disputed claims 39 percent, and costly refinancings 30 percent. *See also*, James Boyle, Texas Consumer Association, Tr. 40.

Creditors contended that current state law provides adequate consumer protection.[20] Such laws, however, generally do not address either the inclusion of waiver clauses in form contracts or their use for *in terrorem* purposes. The rule provision is aimed squarely at these gaps in state consumer protection schemes.

The preponderance of record evidence causes us to conclude that consumers suffer economic injury, as well as more subjective harm, as a result of practices which flow from the inclusion of this provision in consumer credit contracts.

The rulemaking record shows that most consumers are neither aware of the rights they have under exemption statutes nor of the presence or significance of waiver clauses in their contracts.[21] Creditors do not explain these rights or the contract clause to their customers.[22] Consumers would thus find it difficult to bargain over this provision or shop around

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[20] *See, e.g.*, Herschel Adcock, Louisiana Consumer Finance Association, Tr. 1221; Richard Kohn, Colorado Bankers Association, R-I(a)-472; Clarence Bleser, Wisconsin Finance Corp., Tr. 3476; Burton Caine, Pennsylvania Consumer Finance Association, Tr. 8427.

[21] *E.g.*, Benya F. Marshall, HX-51 at 4; Kayla Vaughn, Missouri PIRG, Tr. 4646-49; Jonathan Epstein, Essex-Newark Legal Services, Tr. 8948; Herbert L. Beskin, Charlottesville-Albemarle Legal Aid Society at HX-377 at 6; Keneth Levin, Atlanta Legal Aid Society, HX-336 at 6. The record contains numerous examples of consumer credit obligations which contain waivers written in nearly incomprehensible legalese. *See, e.g.*, those presented by Daniel W. Molloy, Legal Aid Society of Mobile County, HX-72, Exhs. 1-3 and 5. Thirty-five such notes are included in R-XI-156; other examples are in the consumer account files subpoenaed by the FTC rulemaking staff, *e.g.*, BEN 0100; CIT 0248.

[22] In some states where waivers are permitted, courts disallow them unless made knowingly, voluntarily, and intelligently. *See, e.g., Aetna Finance Co.* v. *Antoine*, 343 So.2d 1195 (La. App. 1977); *Transnat'l. Consumer Discount Co.* v. *Kefauver*, 224 Pa. Super. 475, 307 A.2d 303 (1973). *See also* Herbert Beskin, Charlottesville-Albemarle Legal Aid Society, Tr. 8993; Presiding Officer's Report at 107-108.

for contracts without one.[23] Thus, consumers cannot reasonably avoid the injury caused by waivers of exemption clauses.

D. Offsetting Benefits

Some opponents of this provision contended that some exempt property has economic value as collateral, and that waivers of exemption are necessary to threaten debtors with seizure of the property as means of inducing payment.[24] This contention assumes that debtors fail to pay on time because they are unwilling to do so. The assumption is contradicted by the finding that most debtor default is the result of factors beyond the debtor's control.[25] To the extent that the clause has any value as a collection device, creditors still have a large number of remedies at their disposal.[26]

A few witnesses predicted that the effect of prohibiting waivers of exemption would be to increase the cost of credit or restrict its availability.[27] In those states that permit waivers, however, the record shows that they result in actual seizures relatively infrequently;[28] this strongly suggests that creditors

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[23] Indeed, some waivers operate to deny consumers their exemptions even if they move to another jurisdiction. *See, e.g.*, BEN-0018: "* * * waive all rights of exemption under the laws of this or any other state."

[24] *See, e.g.*, C.P. Brocato, Louisiana attorney, R-II(c)-40; Richard Van Winkle, Utah Consumer Finance Association, Tr. 7607; Richard P. Ogle, Alabama attorney, R-II(c)-7.

[25] *See supra* Chapter III.

[26] *E.g.*, garnishment, self-help repossession, direct contacts with the debtor, purchase money security interests, etc.

[27] *See, e.g.*, Robert P. Shay on behalf of the National Consumer Finance Association: "While one can easily assume that such waivers accentuate economic disaster when they hit, there is no doubt in my mind that the taking of such waivers with the consent of the applicant enables creditors to extend credit more prudently to applicants of marginal creditworthiness who might otherwise have to be denied credit * * *." HX-494 at 38.

[28] *See, e.g.*, Herbert Beskin, Charlottesville-Albemarle Legal Aid Society, HX-377 at 5-6; Kenneth Levin, Atlanta Legal Aid Society, HX-336 at 7; NCLC survey results, HX-467 at 33; Karl Friedman, Alabama Consumer Finance Association, Tr. 63.

themselves consider waivers to be of little value.[29] The Presiding Officer found that creditors are generally reluctant to effectuate executory waivers even where both the opportunity and statutory authorization to do so exist.[30]

Based on the evidence, we conclude that the benefits outweigh the costs for this provision. This is consistent with the Presiding Officer's finding that: "taken as a whole, the record supports a conclusion that the prohibition on executory general waivers of all homestead and other exempt property in consumer credit contracts would prevent consumer abuses without doing undue harm to creditors."[31]

E. Alternatives Considered and Modifications Adopted

This provision of the proposed rule received wide support throughout the proceeding. Creditor objections focused on a possible ambiguity which could lead to misinterpretation of the rule. Creditors were concerned that this prohibition, as originally proposed, would outlaw security interests in exempt property as well as waivers of the statutory exemptions, because in some jurisdictions a security interest was styled as a waiver of an exemption for the covered property. The provision we adopt has been revised to make it clear that § 444.2(a)(2) does not apply to security interests in such property if otherwise permitted by the rule and by state law.

As enacted, § 444.2(a)(2) prohibits the use of "executory" or "advance" waivers where there is no security interest in the

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[29] Additionally, the legal status of a waiver of exemption prevents the creditor from regarding the affected property as a source of significant protection. The waiver does not diminish the property-owner's power of control or alienation because it does not act as a lien or security interest. *See, e.g., Kroenert* v. *Mead*, 59 Kan. 885, 54 P. 684 (1896); *Benning* v. *Hessler*, 144 Minn. 403, 175 N.W. 682 (1920).

[30] Presiding Officer's Report at 112-13.

[31] Presiding Officer's Report at 114. *See also id.* at 307.

affected property. Many creditors agree with, or at least have no objection to, this provision as modified.[32]

The provision will not affect existing state law which prohibits enforcement of executory waivers of exemption. But it will prevent creditors from employing executory waiver clauses in all jurisdictions regardless of their enforceability under state law.

VIII. Late Charges

Section 444.4 of the Rule provides that it is an unfair act or practice for a lender or retail installment seller to use any accounting or other method that results in the assessment of multiple late charges based on a single late payment that is subsequently paid.

A. Nature of the Practice

Late or delinquency charges are those the creditor assesses against the borrower when a payment is not made by the due date, although there is usually a grace period of five or ten days before the late charge is imposed. Deferral or extension charges are made by the creditor for extending the period of time within which the debtor may make one or more payments. Late and deferral charges both have a dual purpose. The first is to encourage the debtor to make timely payments; the second is to compensate the creditor for additional costs resulting from a failure [7771] on the part of the debtor to make payments in accord with the terms of the loan agreement.

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[32] *See, e.g.*, Post-record Comments; Banks, XV-92, 105, 110, 117, 125, 170, 233, 235, 322, 331; Credit Unions, XV-124, 128, 142, 143, 168, 202, 225, 228, 274, 329.

The importance of the incentive effect of late charges was emphasized by creditors.[1] Late charges prevent a debtor from converting a precomputed installment contract or a loan into open end credit.[2] When a consumer is late in making a payment under a precomputed credit contract, the creditor may receive no income for the period of delay; and the delinquent debtor can effectively pay a lower rate of interest than charged consumers who pay on time.[3]

The rulemaking record demonstrates that creditor efforts to collect delinquent payments result in costs significantly greater than those associated with the maintenance of current accounts.[4] These costs include those attributable to

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[1] *e.g.*, W. A. Owens, Public Investors, Inc., R-1(a)-414; Robert L. Ernst, Butler Financial Corporation, Tr. 4166; Helmut Schmidt, Transamerica Financial Corporation, Tr. 6197; David F. Steuber, Standard Oil of California, R-1(a)-238; F. T. Weimer, Sears Roebuck & Company, R-1(a)-427; Jerry T. Bringard, Ford Motor Credit Company, R-1(a) 816; Robert C. Downing, Hudson, Potts & Bernstein, R-1(a)-314, J. William Breman, U.S. League of Savings & Loan Association, R-1(a) 648.

[2] *e.g.*, William G. Thomas, Virginia Consumer Finance Association, Tr. 9175; W. Bhett Tanner, Georgia Consumer Finance Association, HX-171 at 21-22; Don L. Pratt, Indiana Consumer Finance Association, Tr. 3098; GMAC Rebuttal Submission, R-XIII-23 at 31.

[3] T3 *e.g.*, Robert E. Dean, Security Mutual Finance Corp., Tr. 166. Some state statutes provide for the conversion of a precomputed loan to an interest-bearing loan, but there are, of course, costs in doing so.

[4] *See, e.g.*, William Lehye, Consumer Loan Company, HX-160; Bernard J. Cunningham, Connecticut Consumer Finance Association, TR. 8582; David A. Brooks, Crocker National Bank, Tr. 7931; Richard K. Slater, Consumer Bankers Assn., Tr. 11628; P. Juckett, United California Bank, R-II(d)-78; Harvey Lynch, California Savings & Loan League, Tr. 5219; Vernon Lemons, Jr., Texas Finance Institute, TR. 992-3; R. W. Brooks, First National Bank of Pennsylvania, R-I(a)-246; Patrick W. Harrison, Commerce Union Bank, R-I(a)-195; Robert E. Dean, Security Mutual Finance Corporation, TR. 166; Richard E. Edwards, Pennsylvania Consumer Finance Association, TR. 8507; Teruo Himoto, Hawaii Consumer Finance Association, TR. HX-218 at 10; K. E. Buhrmaster, New York State Bankers Association, R-I(a)-200; A. E. Lewert, Allstate Enterprises, R-I(a)-885; Peter Cumeriengo, First City National Bank of Houston, R-I(a)-502.

additional notices, letters, telephone calls, and personal contacts. The salaries of personnel engaged in such activities are also substantial.[5] To help recover these costs, almost every consumer credit contract contains a provision for the assessment of late charges.[6]

Pyramiding

The practice addressed by revised § 444.4 is known as the "creeping" or "pyramiding" late charge. It comes about by application of an accounting method which results in the assessment of multiple delinquency charges due to a single late payment. The general accounting principle is that payment is first applied to any outstanding late charge, then to the interest charge, and finally to the principal amount of that payment. In "pyramiding" the accounting method works in this fashion: If a consumer's payment is due on the first day of January, for example, and the payment is not made until the 20th day of that month, the creditor assesses a late

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[5] *E.g.*, Teruo Himoto, Hawaii Consumer Finance Assoc., Tr. 5388; Alfred J. Lapan, South Middlesex Cooperative Bank and Massachusetts Cooperative Bank League, Tr. 11479. *See also* collection procedure described by Oscar M. Zeno, Puerto Rico Consumer Finance Association, HX-351 at Exh. 2; William E. Wehner, Household Finance Corporation, Tr. 9085; Hyman Weiner, California Loan and Finance Association, Tr. 6488-89; Harvey A. Lynch, California Savings and Loan League, HX-206 at 12; Arthur L. Bronstein, Industrial Bankers Association of Colorado and Colorado Consumer Finance Association, Tr. 5815.

[6] *E.g.*, Consumer Bankers Association survey, HX-490 at Table 6; NCLC Survey of Consumer Law Specialists, HX-467 at 37-38. The National Consumer Law Center reported that legal aid attorneys considered every creditor provided for such charges for an average frequency of 87 percent, that such charges were actually made about 77 percent of the time they were authorized, and that they were included as a part of the claim when suits were filed about 71 percent of the time. HX-467 at 37-38. The Consumer Bankers Association reported the inclusion of late charge provisions in contracts in 86 percent of the personal loans and in 96 percent of indirect automobile loans. In collection suits the provision was used 44 percent of the time as part of the claim in personal loans and in 56 percent of the actions on indirect auto loans. HX-490 at Table 8.

charge, for example, $5. The February payment and all subsequent payments are made on time. However, by allocating $5 of the February payment to the January late charge and only the remainder to the February payment, the creditor causes the February payment to be $5 "short", hence delinquent. Timely payments in succeeding months are given the same treatment, so that there is a delinquency or late charge for each month. The cumulative impact of repetitive late charges can be substantial.

The staff of the Federal Reserve Board provided another example of late payment:

> In some instances when a consumer makes one late payment, the creditor will treat every subsequent payment as being late. For example, where a consumer makes the third monthly payment one month late under an obligation which is to be repaid in six monthly installments, the creditor may then treat the fourth, fifth and sixth monthly payments as each one being one month late and collect a late payment charge for each of those payments.[7]

The Rule provision is aimed at only the first example, or "pyramiding." In the FRB example where the monthly payment is late but never made current, the effect may be to allow the consumer unilaterally to extend the term of the loan. The missed payment on the third month may not be made up until the seventh month, one month after the termination period of the contract. There are mechanisms in most state laws for deferring payments,[8] subject to the creditor's right to assess and collect a deferral—as opposed to a delinquency or default charge.

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[7] HX-451 at 14-15.

[8] *See, e.g.*, Wis. Stat. § 422.203-204 (1972); U3C §§ 2.204, 3.204 (1968), and § 2.502 (1974); *see generally* CCH Consumer Credit Guide ¶520 at 1401 *et seq.*

B. State Law

States have imposed limitations on the amount that creditors may assess consumers for late charges and deferral fees. The most frequently used state method is to put a "cap" on late charges equal to 5% of each installment more than ten days late or $5, whichever is less. Some states also put a "floor" of 50¢ or $1 on these charges to partially compensate the creditor for its added expense of collecting the late payment.[9] States that have adopted the Uniform Consumer Credit Code expressly prohibit pyramiding of late charges.[10]

C. Prevalence

The record establishes that consumer credit contracts almost uniformly provide for the assessment of late charges and extension charges, although they may not always be assessed.[11] Such charges can be waived to assist debtors in financial distress or to facilitate settlement of delinquent accounts.[12] Although the precise extent of pyramiding of late charges cannot be ascertained from the record, there is evidence that it occurs in most of the [7772] states where it is not

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[9] Presiding Officer's Report at 193-94.

[10] *E.g.*, Colo. Stat. Ann. sections 5-2-203, 5-3-203 (1973); Idaho Code section 28-32-203 (Supp. 1975); Okla. Stat. Ann. tit. 14A, sections 2-203 to 204 (1963).

[11] Many witnesses reported that late charges are frequently waived, *e.g.*, Richard E. Edwards, Pennsylvania Consumer Finance Association, Tr. 8506; David White, National Association of Federal Credit Unions, Tr. 11095; John R. Shuman, Florida Consumer Finance Association, Tr. 3579; Joseph C. Park, Michigan Consumer Finance Association, Tr. 3182; Harvey R. Miller, Gateway Loan Corporation, Tr. 2530; Bernard J. Cunningham, Windsor Locks Finance, Inc., Tr. 8562; James M. Hassenger, Iowa Consumer and Industrial Loan Association, Tr. 3630. *But see* Robert A. Patrick, General Counsel, Wisconsin Office of Commissioner of Banking, who noted that the large corporations generally operate on a computer system, and the taking of late charges would not likely be left to the discretion of local offices. Tr. 4035.

[12] *Id. See also*, Presiding Officer's Report at 203.

specifically prohibited and is sufficiently prevalent to warrant being addressed by this rule.[13]

D. Consumer Injury

The record contains evidence that pyraminding of late charges results in the assessment of charges far in excess of the amounts, if any, actually expended by creditors to collect the account.[14] Indeed the evidence indicates that, where the only delinquency on an account is attributable to a prior late charge, creditors do not persist in collection attempts.[15]

The problem of pyramiding—where a payment is late but is paid in full on or before the next timely payment—is compounded by the fact that the debtor is usually unaware that the late charges are "pyramiding" until the final payment is made.[16] If payments are accompanied by a coupon from a book of coupons given to the consumer at the time the credit is extended the debtor may not receive any periodic statement indicating the amount of late charges as they accrue.

Furthermore, because pyramiding is based on an accounting method, not a contract provision, consumers cannot shop around for credit contracts that do not involve this practice,

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[13] *See e.g.*, Professor John Spanogle, State University of New York at Buffalo, Tr. 9745; Robert Hilgendorf, Office of the Attorney General of New Mexico, Tr. 10477; Robert C. Focht, Director, Consumer Credit Division, Connecticut Banking Department, Tr. 11255-56; James L. Brown, University of Wisconsin Center for Consumer Affairs, Tr. 4070-72. *See also*, R-XI-ASSOC-242 (Washington); ASSOC-378 (South Carolina); GFC-230 (Louisiana); GFC-65, 69 (Texas); DIAL-76 (Connecticut); CTA-85 (Washington); BEN-119, 129 (New York); CIT-262 (Ohio); R-XI-TF-5-13 at 1409A-B, R-XI-CIT-E at SF403 (finance company manuals containing instructions regarding "pyramiding" late charges); GMAC Rebuttal Submission, R-XIII-23 at 34; and note 17, *infra*.

[14] Note 3, *supra*. *See also* Presiding Officer's Report at 195, and note 16, *infra*.

[15] *See* consumer files cited in note 13, *supra*; *see also* notes 16, 18, *infra*.

[16] *See, e.g.*, R-XIII-26, consumer complaint #538-77 (South Carolina Department of Consumer Affairs); R-XI-185, memo from Dial Finance Branch Manager to Washington consumer, April 28, 1975.

or otherwise reasonably avoid the injury which flows from its application. This provision will benefit borrowers by reducing late charges assessed for a single late payment.

E. Offsetting Benefits

Only one participant in this proceeding defended the use of pyramiding late charges,[17] arguing that the creditor, seeking to make the account current, incurs collection costs during each period the installment remains unpaid. Because of this continuing effort, the creditor should be permitted to impose a late fee in each period that even a small amount remains unpaid to partially cover the cost of collection efforts during that period.

The evidence, however, establishes that creditors do not persist in collection efforts after a tardy payment is received and the only deficiency is a prior late charge.[18] Where a payment is late but subsequently received, creditors make no further efforts to collect. Therefore, they do not need to be reimbursed for collection expenses after the late payment is received.

Pyramiding of late charges is basically the result of an accounting method. It is thus unknown to consumers and could not therefore serve as a useful deterrent to late payments. Because little or no collection effort occurs after a tardy payment is made, the creditor incurs little or no added collection expense. Prohibiting the use of pyramiding will have little, if any, impact on either the cost or availability of credit. Therefore, benefits to consumers or competition are insufficient to offset demonstrated consumer injury from pyramiding of late charges.

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[17] General Motors Acceptance Corporation, R-XIII-23 at 34, note 70.

[18] Notes 13, 16 *supra*. Professor Robert Shay showed that the average cost to the creditor in collecting a late payment was $31.32, while the average revenue received was $9.49. HX-494 at 55-56. Ford Motor Credit Company reported an $18.5 million excess of costs over revenues. R-I(a)-816 at 32. It is unlikely that efficient creditors would expend such sums to recover a late charge as opposed to delinquent principal.

F. Alternatives Considered and Modifications Adopted

Some creditors argued that, because the initial proposal did not address the precise issue of pyramiding, no notice was given of this practice.[19] This is incorrect, because the proposed rule clearly focused on late charges.[20]

As initially proposed, the late charge provision would have prohibited the inclusion of terms in consumer credit contracts permitting charges for late or extended payments that exceeded the amount derived from application of the annual percentage rate governing the transaction to any payment which was late or extended. The evidence adduced in the proceeding does not support a finding that late charges in excess of the APR are unfair. However, the Commission is adopting a revised provision to eliminate "pyramiding" of late charges.

Lenders generally demonstrated that permitted late charges do not always compensate them for the added costs of collecting delinquent payments.[21] Because of this, it is not an unfair practice for creditors to assess a late charge for each payment period that the delinquent principal or interest payment remains unpaid. However, where a tardy payment is paid, and the only deficiency is a late charge imposed on that payment, the late charge itself should not be a basis for imposing further late charges.

Pyramided charges do not compensate creditors for any costs incurred in collection. Such charges simply permit collection of sums over and above principal and interest due; pyramiding constitutes a windfall to the creditor that inflicts

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[19] *See, e.g.*, NCFA comment R-XIII-31 at 103, note 1.

[20] The revised provision can be regarded as a less stringent alternative to the originally proposed rule provision (a)(9), which also would have prevented pyramiding.

[21] *See* Shay, *supra*, note 18.

substantial injury on consumers that is not reasonably avoidable, without countervailing benefits to consumers or competition. Pyramiding of late charges, therefore, is an unfair practice.

Retailers suggested that open-end credit be exempted from this provision of the rule because no late charge provision is used in such contracts.[22] We adopt a revised proposal which would not affect open-end creditors or any other creditors who do not employ this accounting method.

Several parties argued that late charges should not apply where a partial payment is made. There is inadequate record evidence to justify prohibiting late charges on partial payments. A partial payment, unless it is only partial because of previously due late charges that were "late," is a late payment.

Finally, we have determined that a straight-forward prohibition on the practice of pyramiding is sufficient remedy. Earlier proposals incorporated a requirement that creditors include in each consumer credit contract a clause prohibiting pyramided late charges. We find insufficient record evidence to support such a requirement. Our approach will result in no paperwork burden on creditors and will obviate the need for an unnecessary contract provision as to that substantial body of creditors which does not engage in the practice. [7773]

IX. Cosigners

Consumers who do not meet a creditor's standards for creditworthiness are often required to obtain one or more "cosigners" who agree to be liable for the debt. A cosigner is required to pay if the debtor defaults, but the cosigner receives no monetary consideration for undertaking the obligation, which can become onerous.

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[22] *See* Comments on the Presiding Officer's Report and Staff Report at XV-299, XV-345.

A. State Law

The term "cosigner" has no precise legal meaning.[1] The rights and obligations of cosigners are defined by reference to the contracts they sign. The status of a cosigner is that of an accommodation party and surety.[2] The cosigner's obligation is generally the same as that of the principal because cosigners waive traditional rights of sureties.[3]

Except for a few reform statutes, the status of consumer cosigners has not been the subject of legislative or judicial consideration. Most reported cases involve commercial interests. Consequently, the law in this area does not reflect the special problems of cosigners in consumer transactions.[4] In

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[1] Presiding Officer's Report at 266-267.

[2] For a discussion of the legal background, *see* Staff Report at 421-422. A surety is liable upon default of the principal for the full amount of the obligation. The common law does not protect cosigners where they waive their rights. *Massachusetts Bonding & Ins. Co.* v. *Fentz*, 182 F.2d 752 (8th Cir. 1950); *McElroy* v. *Mumford*, 28 N.Y. 502, 28 N.E. 502 (1891).

[3] Restatement of Security section 82, comment (g) (1941). This extended liability also means that where the contract so provides, the surety is liable with the principal for the payment of attorney's fees, late or extension fees, and other penalties though sureties have been held not to be liable for interest above the contract amount or for attorney's fees where the contract did not provide. *Universal CIT* v. *Auerback Cleaners*, 162 N.Y.L.J. at 16 (N.Y. Civ. Ct. 1969). *See, e.g.*, R-XI-CIT-A-902, R-XI-DIAL-202, R-XI-CTA-159, R-XI-ASSOC-23, R-XI-LIB-340, R-XI-GFC-292, R-XI-TA-19, R-XI-BEN-51.

The Dial Financial Corporation Surety Agreement states: "It being the intention hereof that the undersigned shall remain liable as principal[s] until said obligation with charges, if any, has been paid, notwithstanding any act or thing which might operate as a discharge or surety." Dial Form No. 1096 H68 (surety agreement). R-XI-Dial-202.

[4] The reason for the paucity of case law in this area is that cosigner contracts, like others, are construed according to their terms. The agreement which a cosigner executes is a standard form contract drafted by the creditor to create equal liability between debtor and cosigner and to waive any defenses which a surety would otherwise have. Such contracts leave little for the courts to construe in the cosigner's favor, and parole evidence is not admissible in suretyship cases. Peters, *Suretyship Under Article Three of the Uniform Commercial Code*, 77 Yale L.J. 833, 855 (1968).

most jurisdictions, the creditor has no obligation to give the cosigner a copy of the contract or advise the cosigner of the extent of his or her liability.[5]

In its report the National Commission, on Consumer Finance (NCCF) recommended that:

No person other than the spouse of the principal obligor on a consumer credit obligation should be liable as surety, co-signer, co-maker, endorser, guarantor, or otherwise assume personal liability for its payment unless that person, in addition to signing the note, contract, or other evidence of debt also signs and receives a copy of the separate co-signer agreement which explains the obligations of a co-signer.[6]

Section 3.208 of the 1974 version of the Uniform Consumer Credit Code (U.C.C.C.) followed the NCCF's lead with a similar recommendation.[7] Several states require written notice to cosigners.[8]

B. Use of Cosigners

Cosigners were employed in 2 percent of the cases sampled by the National Consumer Finance Association.[9] Individual small loan companies indicated that they use cosigners from

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[5] Presiding Officer's Report at 264.

[6] Report of the National Commission on Consumer Finance, Consumer Credit in the United States 39 (1972).

[7] The U.C.C.C. also requires that cosigners be given a copy of the debtor's contract, as well as the cosigner agreement. For full text, *see* section 3.208.

[8] Wisconsin, Illinois, California, West Virginia, Iowa, Colorado and South Carolina. NCFA Rebuttal Submission, RXIII-31 at C-28. *See also* Staff Report at 425-426, notes 17-26.

[9] Robert P. Shay, National Consumer Finance Association, HX-494, pp. 61-63.

10 percent[10] to 95 percent of the time.[11] A survey by the Consumer Bankers Association showed that 7 percent of responding banks "usually" or "often" encourage cosigners.[12] A survey by the National Consumer Law Center which focused on low-income consumers, reported that legal aid attorneys estimated that finance company creditors use cosigners other than spouses 41 percent of the time, banks use non-spouse cosigners 31 percent of the time, and credit unions use them 20 percent of the time.[13] Finance company files on the record also reflect the use of cosigners.[14] The record establishes that creditors seek and obtain cosigners at

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[10] Harvey R. Miller, Gateway Loan Corp., (10 percent) Tr. 2533; David H. Curtis, Confidential Loan Service, (10 percent) Tr. 2679, Harold T. Welsh, Illinois Credit Union League stated that 15 percent of his credit union's outstanding loans involve cosigners, Tr. 4123, Bernard J. Cunningham, Windsor Locks Finance, Inc., Connecticut, states that his finance company has cosigners on 20 percent of its loans, Tr. 8564.

[11] Jorge Vilches, Puerto Rico Consumer Finance Association, (95 percent) Tr. 8592, Richard C. Durham of the Asociacion Puertorriquena de Financieros del Consumidor cites a survey by that association of the consumer finance industry in Puerto Rico showing that 83 percent of the 353,336 loans outstanding as of March 31, 1975, had cosigners other than the spouse of the principal borrower. R-I(a)-820. Larry B. Kesler, Commalo Co., Inc., Puerto Rico, states that his company makes two-thirds of its loans of under $800 with cosigners. R-I(a)-718.

[12] Richard K. Slater, Consumer Bankers Association, Tr. 11618.

[13] Mark Leymaster, National Consumer Law Center, HX-467 at 35. One finance company stated that some of its loans require as many as six cosigners, so the number of cosigned loans may understate the number of consumers affected by this practice. Jackson W. Guyton, Mutual Savings Credit Union, Fairfield, Al. R-II(1)-80 at 3.

[14] *See, e.g., R-XI-GFC-:* 8, 10, 19, 20, 35, 50, 52, 53, 56, 57, 58, 59, 61, 146, 153, 154, 200, 398; *R-XI-LIB-:* 228, 252, 337, 338, 339, 340, 342, 344, 347, 358, 359, 533, 379, 367, 65, 77, 570; *R-XI-AVCO-:* 93, 164, 323, 351, 459, 822; R-XI-HFC-: 77, 109, 212; *R-XI-GECC-:* 7, 11, 152; *R-XI-ASSOC-:*1, 581; *R-XI-BEN-:* 9, 13, 15, 19, 42, 51, 104, 160, 209, 235; *R-XI-CTA-:* 1, 2, 7, 115, 160; *R-XI-TA-:* 35.

the time of initial extensions of credit and to secure delinquent accounts in a significant number of cases.[15] Some witnesses stated that parents are the most frequent non-spouse cosigners.[16] Other relatives, friends and employers are also used.[17]

C. The Unfairness of Failure To Disclose Cosigner Liability

The consumer injury addressed by § 444.3 of the rule is occasioned in some cases by the failure of creditors to inform potential cosigners of their obligations and liability (an unfair [7774] practice) and, in other cases, by affirmative creditor

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[15] *E.g.*, cosigners were obtained at the time of the initial extension of credit in:

R-XI-DIAL-:87, 90, 112, 123, 128, 37, 40, 44, 58, 63, 138, 146, 148, 153, 154, 156, 159, 174, 178, 193, 204, 210, 215.

R-XI-CIT-:4, 6, 24, 29, 35, 39, 57, 106, 169, 178, 179, 180, 181, 185, 194, 203, 208, 217, 219, 234, 239, 242, 264, 267, 335, 343, 365, 368, 392, 407, 412.

Cosigners were obtained after the initial extension of credit and after a default had occurred in, *e.g.*:

R-XI-DIAL-:31, 42, 43, 45, 46, 48, 57, 64, 129, 134, 175, 191, 193, 200, 202, 217.

R-XI-CIT-:186, 208, 248.

See also testimony of Clare A. Rollwagen, Maryland Consumer Finance Conference, Community Credit Company, Tr. 3967.

Cosigners were solicited after serious delinquency on the part of the principal debtor in, *e.g.*:

R-XI-DIAL-:8, 9, 10, 11, 12, 13, 14, 15, 16, 19, 20, 21, 33, 38, 41, 56, 61, 102, 111, 113, 115, 127, 136, 137, 158, 172, 213, 214.

R-XI-CIT-: 212, 216, 223, 249, 250, 255, 258, 259, 273, 287, 288, 291, 301, 318, 324, 343, 385, 428, 434.

[16] *E.g.*, Joe Martin, 1st United Bancorporation, Tr. 1165.

[17] *E.g.*, Ronald L. Polk, Arizona Consumer Loan and Finance Association stated that their practice is to take only immediate family members as cosigners, R-I(a)-460 at 3. Robert E. Ericson, DNA Legal Services, Window Rock Reservation, stated that parents, relatives, and friends are obtained as cosigners in his experience, Tr. 1675. Charles L. Childers, Tyler Bank and Trust Company and Texas Bankers Association, states that employers are also usual cosigners, Tr. 1200. Ford Motor Credit estimates that more than half of its non-spouse cosigners are parents or other relatives, R-I(a)-816.

misrepresentations concerning such obligations and liabilities (a deceptive practice). Section 444.3(a)(2) of the rule provides that it is an unfair practice to fail to disclose to a potential cosigner the nature of the liabilities undertaken by becoming a cosigner.

The record establishes that creditors fail to disclose the nature and extent of cosigner obligations. Although some creditors stated that they explain the implications of cosigning a loan,[18] and may do so quite colorfully,[19] the preponderance of evidence causes us to conclude that a large number of creditors are not so enlightened. Finance company operating manuals included in the record do not instruct their employees to provide an explanation.[20] Creditors testified that they do not provide cosigners with explanations of the obligation undertaken,[21] and that they often never see the cosigner, but direct the principal debtor to obtain the signature of a friend or relative on the contract.[22] Thus, failure to disclose the nature and extent of cosigner liability is prevalent.

1. Consumer Injury

As might be expected, creditors seek to collect from cosigners when the principal debtor defaults. In the NCFA sample, creditors demanded payment from cosigners in 74.7 percent of the precomputed loans and 72.5 percent of per diem loans

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[18] *E.g.*, William Probasco, Mid Valley Time Loan and President, California Loan and Finance Associations, Tr. 6146; Don E. Lewis, American Bank and Trust Co., North Carolina, R-I(a)-81.

[19] "I generally tell any cosigner that a cosigner is a damn fool with a pencil." George Bartlett, Home Credit Company, Wyoming, Tr. 7776.

[20] One finance company's training manual directs employees to provide copies of documents to cosigners (AVCO Manuals, R-AFS5), but the training manuals of other companies are silent on the subject. *See generally*, finance company manuals in record binders 215-42-1-12(1-1) through (1-19).

[21] *E.g.*, Carl B. Friedman, Alabama Consumer Finance Association, Tr. 97.

[22] *E.g.*, Joe Martin, 1st United Bancorporation, Tr. 1158; Jackson W. Guyton, Mutual Savings Credit Union, Alabama, R-II(1)-80 at 3.

upon default.[23] A banker stated that his bank collects from cosigners in 75 percent of all defaults.[24] The evidence shows that cosigners are relied upon for repayment by creditors, and are subject to the full range of collection tactics, including those addressed by other sections of this rule.[25] The sudden liability that can result from cosigner status can cause over-extension when a consumer is confronted with a debt, the timing of which cannot be controlled by the cosigner because it is due to nonpayment by the principal debtor. A study by David Caplovitz indicates that 6 percent of all consumer defaults is due to cosigner liability.[26]

Because of the range of potential liabilities, many consumers might not have become cosigners had they known the

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[23] Robert P. Shay, NCFA, HX-494 at 61-63. NCFA 1975 Financial Facts Yearbook quoted by W. E. Van Norman, American Investment Company, St. Louis, R-II(1)-330 at 4.

[24] Joe Martin, 1st United Bancorporation, Tr. 1157.

[25] *E.g.*, R-XI-DIAL-37, 44, 46, 57, 58, 87, 90, 112, 123, 128, 174, 191, 193, 204, 210, 215, 217. In file 175, a note of 10/8/70 says, "called sur. (surety, the debtor's mother) and gave good grind. S[he] all upset." R-XI-CIT-6, 24, 35, 206, 208, 219, 248, 287, 343, 362, 407, 416. Cosigners' household goods were taken as security, R-XI-DIAL-158, 174. *See also* testimony of Hyman Weiner, Tr. 6483. In R-XI-CIT-242 and R-XI-LIB-338 and 366 wage assignments were taken from cosigners. Additional evidence of this practice is found at R-XI-186, #2.

Suit and judgment against cosigner: See, for example, R-XI-DIAL-40, 174, 191, 215, 217, and R-XI-CIT-4, 29, 35, 38, 57, 100, 194, 219, 239, 324, 343.

Garnishment of cosigner's wages: *E.g.*, R-XI-CIT-100, R-XI-CIT-178, 185, 219, 324, and R-XI-AVCO-822.

Threats directed to cosigner: *E.g.*, R-XI-CIT-169.

[26] Caplovitz, *Consumers in Trouble*, (N.Y. 1974), p. 77.

likely costs of doing so.[27] When cosigner obligations are explained:

A whole bunch of them have said "never looked at it that way * * * ain't no way I'm going to do this." (Henry Goodman, Arizona Finance Co., Tr. 7763).

Cosigners thus undertake obligations which they might not have undertaken had they understood them, and suffer economic and other hardship as a result when called upon to repay.[28]

2. Reasonable Avoidance

Despite the high likelihood that they will be asked to pay in the event of default, many cosigners are unaware of the nature of the obligation they undertake absent a disclosure. Some believe that they are merely acting as a reference.[29] Legal aid attorneys estimate that only 20 percent of cosigners understand the nature and extent of their obligation.[30] Although some cosigners are aware of the basic fact of liability,[31] even cosigners who realize that they are not merely

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[27] *See, e.g.*, Patrick C. Ryan, Administrator, Consumer Affairs, State of Oklahoma, Tr. 753; Bryce A. Baggett, Oklahoma Consumer Finance Association, Tr. 880-92; Sidney Margotius, columnist, New York, Tr. 11208, R-XI-181-01; R-II(1)-414.

[28] *See supra* notes 25-27.

[29] *E.g.*, Nancy L. Henry, Community Assistance Program, Antipoverty Program of Racine, Wisconsin, Tr. 5554; R-XI-HFC-157; Robert C. Focht, Director of Consumer Credit Division, Connecticut Banking Department, Tr. 11246; Ben. T. Reyes, Texas State Representative, Houston, Tr. 1660; Drew Johnson, Lane County Legal Services, Inc., Oregon, Tr. 6319; John F. Robbert, Louisiana Consumer League, Tr. 1968; Alan D. Burke, Legal Services, Legal Education Program, Indiana, R-I(c)-31; Barry H. Powell, Community Legal Services of Mississippi, Inc., R-II(1)-122. Some evidence indicates that this may be true for a majority of cosigners. Mark Leymaster, National Consumer Law Center, HX-467.

[30] NCLC Survey, HX-467 at 36.

[31] *E.g.*, Leslie R. Butler, Consumer Bankers Association, HX-486 at 18; Gayle C. Williams, Legal Aid Society of St. Louis, Tr. 4620-21; Craig James, Idaho Legal Aid Society, Tr. 7071-72; David R. Duhon, North Louisiana

references are often not fully aware of the extent of their obligation.[32]

At common law, creditors had an obligation to exhaust their remedies against the principal before seeking payment from a cosigner.[33] This requirement was consistent both with the economic role of the cosigner in the transaction and with cosigners' expectations.[34] Many current cosigner contracts, however, contain a waiver of the requirement that the creditor first pursue the principal.[35] Thus, upon default, the cosigner may be required to pay even if the principal has assets from which the creditor could be paid.[36] Some finance company manuals instruct employees to make cosigners the focus of collection efforts once the principal debtor has become more than minimally delinquent.[37] [7775]

Legal Assistance Corporation, Tr. 1480 U-V; Fernando Acevedo, Esq., Tr. 8656.

[32] *E.g.*, Agnes C. Ryan, Legal Aid Bureau of Chicago, Tr. 2235-36; Kayla Vaughan, Missouri Public Research Group, Tr. 4659; Gayle C. Williams, Legal Aid Society of St. Louis, Tr. 4609-12; Jonathan Epstein, Essex-Newark Legal Service, Tr. 8959; Sidney Margolius, columnist, New York, Tr. 11208; Drew L. Johnson, Lane County Legal Aid Service, Inc., Tr. 6319; Judge Arthur L. Dunne, Cook County, Illinois, Tr. 2738. Some industry members agreed that cosigners do not fully understand their liabilities; *see, e.g.*, Robert P. Shay, NCFA, HX-494 at 59-60; Bryce A. Baggett, Oklahoma Consumer Finance Association, Tr. 895-96. *See also* Presiding Officer's Report at 272-276.

[33] The common law background of cosigners' liability is reviewed in detail at pp. 421-424 of the Staff Report.

[34] *E.g.*, Gayle C. Williams, Legal Aid Society of St. Louis, Tr. 4609; Royal White, White Systems, of Jackson, Inc. and Mississippi Consumer Finance Association, Tr. 205; FTC New York Regional Office Study, R-XI-8; Lois J. Wood, Land of Lincoln Legal Assistance Foundation, East St. Louis, Illinois, R-I(c)-19; consumer complaint letter, R-XI-186; Thomas J. Tahnk, Supervisor, Minnesota Office of Consumer Services, Tr. 2991.

[35] *See, e.g.*, R-XI-CTA-62, R-XI-ASSOC-92, R-XI-LIB-125, R-XI-CIT-A-902. *See also*, R-XI-185-02.

[36] *See, e.g.*, R-XI-DIAL-12; Mary K. Gillespie, San Francisco Neighborhood Legal Assistance Foundation, HX-224.

[37] *E.g.*, DIALogue #3. Collection Conversations, Dial Form 270 G70, p. 4 R-XI-DF-8. Branch Manual, Collections, Letters, and Forms for Early

Of course, the contract a cosigner signs sets forth the basic fact that the cosigner is liable. Thus, potential cosigners might avoid the injury that stems from the creditor's failure to disclose by carefully reading the contract document itself. The question is whether, in the circumstances, consumers can reasonably avoid injury by reading and understanding the contract.

The record reveals in these circumstances they cannot.[38] As noted earlier, consumer credit contracts are written in technical language that is difficult for consumer [sic] to understand.[39] The record also indicates that cosigners are no more likely than other consumer borrowers to comprehend contract language.[40] Moreover, most cosigners are not provided with copies of the documents they sign or of documents received by the primary debtor.[41] In any event, the entire

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Collection Efforts, No. 6311:1 R-XI-DF-9. Write Letters Right, Dial Finance Company, Letter to Endorser, p. 33, R-XI-DF-7. The Job Ahead: Credit Manager, Dial Finance Company, Collection Chart, p. 28, R-XI-DF-3.

[38] In other circumstances, Section 5 may not require a disclosure of the meaning of the contract. If the contract were clear and understandable, consumers could reasonable [sic] avoid injury by reading the contract itself. Thus, the prerequisites for a finding of unfairness would not be met.

[39] *See supra* Chapter III.

[40] *E.g.*, Leslie R. Butler, Consumer Bankers Association, HX-488 at 18.

[41] *E.g.*, HX-491 at Questions 2(a) and 2(b); James Hix, National Bank of Commerce, Dallas, Tr. 1934; Toby J. Rothchild, Legal Aid of Long Beach, California, Tr. 6804; Consumer Complaint Letters, R-XI-186, R-II(b)-414; H. Robert Erwin, Jr., Legal Aid of Baltimore, Tr. 10027-28, 10066; Cary Reisman, Legal Aid Foundation of Los Angeles, Tr. 7145; Scott Williams, Charlottesville-Albermarle Legal Aid Society, Virginia, R-XVI-15; George Corsetti, Michigan Association for Consumer Protection, Tr. 10503; consumer complaint letter, R-II(1)-317; Harold T. Welsh, Illinois Credit Union League, General Foods Employee Credit Union of Kankokee, Illinois, Tr. 4127; Robert L. Hancock, Southside Loan Company, Georgia, R-II(c)-34; Burton Caine, Pennsylvania Consumer Finance Association, Tr.8446; William I. Levenson, National Home Furnishings Association , Tr. 8355; B.M. Tapley, Harter Bank and Trust, Ohio, R-II(c)-38; R-II(1)-414; R-XI-DIAL-174 and R-XI-185-01.

transaction is often conducted very quickly,[42] leaving little opportunity for the potential cosigner to consider the contract carefully.

In addition, the circumstances under which cosigners are solicited make it unreasonable to expect the potential cosigner to read and consider the contract. Consumers who might otherwise be attentive to the nature of agreements they enter into may be less cautious when they agree to be cosigners. Cosigners are often sought under circumstances that may not allow for a decision in the cosigner's best interest.[43] Many loans in which the creditor seeks a cosigner would not be made if a cosigner is not obtained.[44] Thus, cosigners may be subject to pressure from both the borrower, who may urgently need the loan, and the creditor, who may question the cosigner's loyalty to the borrower if he or she hesitates to cosign. [45] In such circumstances, cosigners may be reluctant to explore fully the legal ramifications of their actions.

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[42] *See infra* note 53.

[43] *E.g.*, Pamela Piering, C.A.M.P. Consumer Action Project, Tr. 6877; Steven P. McCabe, Consumers League of New Jersey and Legal Services of New Jersey, Tr. 87339-8740; [sic] Ronald A. Gall, Wisconsin Consumers League, Consumer Budget Counseling Service, Tr. 3976; Joseph Elder, Legal Aid of Louisville, Tr. 3271; Gayle C. Williams, Legal Aid Society of St. Louis, Tr. 4612.

[44] *E.g.*, Leslie R. Butler, Consumer Bankers Association, HX-486 at 25; Bryce A. Baggett, Oklahoma Consumer Finance Association, Tr. 890-94. *See, e.g.*, Robert P. Shay, NCFA, HX-404 at 60.

[45] *See, e.g.*, the CIT Loan Procedure Manual:

"The customer will usually be very receptive to contacting his relatives, because you have * * * (c)aused him to think in terms of personal losses such as security, etc."

" * * * it is not desirable to contact a professional man when other qualified signers are available because professional friends or relatives are inclined to consider themselves experts on financial matters and often prefer to give lengthy financial advice and counseling rather than to actually cosign the note."

"Should the prospective endorser hesitate, ask questions such as 'You do trust (Joe), don't you?' "

Thus, the record establishes that cosigners often incur liability but are seldom informed of their liability. Because they are frequently not aware of the nature and extent of their obligation,[46] cosigners cannot reasonably rely on their general understanding of the transaction to avoid injury. Because the contract itself is difficult to understand and may be available only briefly, consumers cannot reasonably avoid injury by relying on the contract itself. For these reasons, the Commission concludes that cosigners cannot reasonably avoid the injury that stems from the creditor's failure to disclose.

3. Offsetting Benefits

This record contains substantial evidence that creditors do not now provide cosigners with the information they need to make informed decisions, and that considerable pressure attends the solicitation of cosigners in connection with the collection of delinquent debts.[47] The detriment to cosigners from the lack of information is not offset by benefits to consumers or competition.

Certain benefits may flow to the consumer who is the principal debtor for a cosigned loan, and there may be benefits to competition from the greater number or size of loans which can be extended when a cosigner shares liability for the debt. The rule, by leaving the use of cosigners unaffected, will have no effect on any such benefits. The rule will insure that an

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"The prospective signer is at the psychological disadvantage of having his decision known immediately to his relative or friend. If handled tactfully and efficiently, he will almost always sign the note in preference to having his relative or friend feel that he does not trust him or is unwilling to assist in his time of need."

"Always obtain the co-maker's signature as soon as he has indicated his willingness to sign." (emphasis is original).

"The actual signing of the co-maker should precede your interview for basic application information * * * do not jeopardize the co-maker's signing by pursuing at length the completion of application * * * ." R-XI-CIT-E, § L418 at 16-18.

[46] *See supra* notes 10, 13.

[47] *See supra* notes 21-22, 43, 45.

informed decision is made prior to consummation of a cosigner agreement.

The primary offsetting benefit of failing to disclose liability is that creditors thereby avoid the cost of making the disclosure. Testimony based on creditor experience, however, suggests that the cost of providing the cosigner with the required disclosure will not be great.[48] Moreover, some creditors testified that they now provide such notices to cosigners or conduct interviews with them.[49] Others stated that they were not opposed to providing a notice and predicted that it can be provided without difficulty.[50]

4. Summary Concerning Unfairness

Failure to disclose produces injury because the extent of liability is a material fact that would likely affect the

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[48] *E.g.*, Mel Nestlerode, National Association of Federal Credit Unions and Manager, CCI-Marquardt Federal Credit Union, Tr. 7219-20.

[49] The following creditors stated that they presently interview or counsel cosigners concerning their liability: Mel Nestlerode, National Association of Federal Credit Unions and CCI-Marquardt Federal Credit Union, Los Angeles, Tr. 7220-7221; Bernard J. Cunningham, Connecticut Consumer Finance Association and Windsor Locks Finance, Inc., Windsor Locks, Connecticut, Tr. 8564. The following creditors stated that they now give a notice similar to that required by the rule: Merced School Employees' Federal Credit Union, Merced, California, R-II(1)-59; The West Bend Co., Wisconsin, R-II(1)-402; Hyman Weiner, Atlantic Finance Co. and California Loan and Finance Association, Tr. 6487; Marcus A. Brown, Island Finance Corp. of Puerto Rico, Tr. 1359.

[50] *E.g.*, J. M. Tapley, The Harter Bank and Trust Co., Ohio, R-II(1)-162; 1st City National Bank of Houston, R-II(1)-236. One creditor suggested that providing the notice would ultimately decrease creditor cost:

"If a cosigner does not have a clear understanding of his obligations and a full and complete acceptance of his obligations, then it makes collection much more difficult and consequently increases collection costs to the creditor. Accordingly, we commend the language in the proposed notice and suggest that even if it is not adopted in the rule that it would be well for creditors to use it voluntarily." Vernon Lemens, Jr., Texas Finance Institute, Tr. 1021-1022.

cosigner's willingness to undertake the [7776] obligation.[51] Consumers cannot reasonably avoid injury because lenders do not explain or disclose liability and there are no low cost alternative sources of information. Many potential cosigners might choose differently if they had full information on the extent of their obligations and liability. The offsetting benefits of avoiding the cost of disclose [sic] are minimal. We conclude, therefore, that failure to disclosure [sic] cosigner liability is unfair.

D. Deceptive Representations Concerning Cosigner Liability

The record shows that in some instances creditors misrepresent the nature of cosigner liability.[52] A legal services representative described questionable representations made to his clients when they cosigned:

We have litigated seven cases where cosigners have been sued for payment when the principal defaulted and have found the scenario runs somewhat like this. At the time of the initial contract the salesman will explain to the principal that their credit is unestablished (or bad) and that the business needs someone to "vouch" for the principal's honesty, ability to pay, whatever. One strand is common, at no time is the cosigner told "you will be liable for payments if the principal defaults." Sometimes the cosigners are told that they are

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[51] Nondisclosure of material facts has been held to violate Section 5 in a wide variety of circumstances. *See All-State Industries, Inc.* v. *F.T.C.*, 423 F. 2d 423 (4th Cir.), *cert. denied*. 400 U.S. 828 (1970); *Alberty* v. *F.T.C.*, 182 F. 2d 36 (D.C. Cir.), *cert. denied*, 340 U.S. 818 (1950); Statement of Basis and Purpose, Trade Regulation Rule, Labeling Advertising of Home Insulation ("R-Value"), 44 FR 50218 (1979), 16 CFR 460; Statement of Basis and Purpose, Trade Regulation Rule, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 FR 59614 (1978), 16 CFR 38.

[52] *E.g.*, Nathaniel Hamilton, Colorado Rural Legal Services, Inc., describes an instance in which a finance company agent stated that all that the cosigners, elderly parents of the principal debtors, were signing were papers creating a corporation, R-II(1)-373. *See also* R-XI-AVCO-93; Joe Martin, 1st United Bancorporation, Tr. 1158; Jackson W. Guyton, Mutual Savings Credit Union, R-II(1)-80 at 3.

witnesses to the contract, and at any rate the entire transaction is handled very quickly. The note is then discounted and when default occurs, there is only testimony of the cosigner as to what the salesman said at the time of the original signing. Of course, the business is no longer a party and the salesman is most likely gone, (and so then is the cosigner's money.)[53] Similar practices are apparent in the following case history offered by a consumer:

> [My husband] was asked by his brother to sign some papers. I said I didn't want to get involved with any cosigning. But Dial Manager and [the debtor] said it wasn't cosigning. It was just a note of agreement to [the debtor's] character. So my husband signed it. But I still refused to so I didn't. Now Dial is trying to make us pay Dial for the [debtor's] bill because they claim my husband signed a cosigner note. And can take him to court if he doesn't pay They never did give him a copy of what he signed.[54]

The nature of such deceptive practices makes detection difficult, and the rulemaking record does not permit a precise measure of the prevalence of outright deception. Nonetheless, the clear evidence of affirmative misrepresentations which do appear on this record[55] convinces us that deceptive practices in connection with obtaining cosigners are sufficiently prevalent to warrant application of our remedial authority.

The Commission's authority to prohibit consumer deception in the marketplace is well established. The Commission

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[53] Joshua M. Landish, Clark County Legal Services Program, Las Vegas, R-II(1)-398 at 4.

[54] Consumer complaint to Washington State Attorney General, R-XI-185-01.

[55] *See, e.g.*, H. Robert Erwin, Jr., Legal Aid Bureau, Inc., Tr. 10025-27; Vincent Alfera, Summit County Legal Aid Society, Tr. 3653; Lloyd B. Snyder, Legal Aid Society of Cleveland, Tr. 2618; Ben T. Reyes, State Representative, Texas, Tr. 1660BB; Herbert L. Beskin, Charlottesville-Albemarle Legal Aid Society, Tr. 9007-08; John F. Robbert, Louisiana Consumers' League, Tr. 1968; Alison Steiner, Central Mississippi Legal Services, Tr. 1767.

and the courts have developed an extensive body of law concerning deceptive practices that proscribes misleading conduct. According to these well established principles, Section 5 is violated whenever a creditor misrepresents to a consumer facts that are material to the consumer's decision.[56]

In evaluating the meaning of a representation and its likely impact on a consumer, the Commission takes into account all of the circumstances surrounding the transaction.[57] Of course, the contract document itself contradicts misrepresentations concerning cosigner liability. As discussed above in the context of our finding that the failure to disclose liability is unfair, however, consumers quite reasonably do not read and understand the contract document.[58] In the face of affirmative misrepresentations, it is even less likely that consumers will read and understand the nature of the contract.[59]

A misrepresentation must also be material to violate Section 5.[60] A representation is material if it is likely to affect the

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[56] *See, e.g., American Home Products Corp.*, 98 F.T.C. 136, 368 (1981), *aff'd.* 695 F.2d 681 (3rd Cir. 1982); *Sears, Roebuck & Co.*, 95 F.T.C. 406 (1980), *aff'd.* 676 F.2d 385 (9th Cir. 1982); *National Commission on Egg Nutrition*, 88 F.T.C. 89 (1976), *enforced in part*, 570 F.2d 157 (7th Cir. 1977); *National Dynamics*, 82 F.T.C. 488 (1973), *aff'd.* 492 F.2d 1333 (2d Cir.); *Warner-Lambert*, 86 F.T.C. 1398 (1975), *aff'd.* 562 F.2d 749 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 950 (1978).

[57] *See, e.g., FTC* v. *Sterling Drug*, 317 F.2d 669, 674 (2d Cir. 1963); *Pfizer, Inc.*, 81 F.T.C. 23 (1972); *Beneficial Corp.* v. *FTC*, 542 F.2d [sic] (3rd Cir. 1976); *American Home Products, supra* note 56.

[58] *See supra* Section C.2.

[59] In *Peacock Buick*, the Commission disagreed with respondent's arguments that contract disclosures obviated the possibility of deception. The Commission noted, "It is clear from consumer testimony that oral deception was employed in some instances to cause consumers to ignore the warning in their sales agreement." *Peacock Buick*, 86 F.T.C. 1532, 1538-9 (1974).

[60] *FTC* v. *Algoma Lumber Co.*, 291 U.S. 67, 81 (1934); Statement of Basis and Purpose, Cigarette Advertising and Labeling Rule, 1965, 29 Fed. Reg. 8325 at 8351 (1954).

consumer's conduct or decision.[61] Express representations, such as a statement that a cosigner is merely acting as a reference for the primary debtor, are presumed to be material, because the creditor's willingness to make the claim reflects a belief that consumers are interested in it.[62]

Moreover, as discussed above, the liabilities of cosigning are substantial, they can subject cosigners to financial and other hardships, including adverse credit ratings and legal process. Indeed, the nature of liability is a central element to the decision to cosign, a fact that strongly argues that misrepresentations of liability are material.[63] Further, many consumers are likely to choose differently when cosigner obligations are explained.[64] Express assertions by creditors that misrepresent the nature of this obligation, and therefore mislead consumers with respect to their potential liability, are clearly material.

In those instances in which misrepresentations of cosigner liability occur, there is clearly deception. The misrepresentations are express, and are likely to mislead consumers. There is injury because information concerning liability is material to the consumer's decision to cosign.

E. Remedial Requirements

Based on the record, we here enact a rule designed to remedy the unfair and deceptive practices discussed above. [7777] The rule declares misrepresentation of the nature or extent of cosigner liability to be a deceptive practice, and the failure to disclose cosigner liability to be an unfair practice. To remedy

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[61] American Home Products Corp., 96 F.T.C. 136, 368 (1981), *aff'd.*, 695 F.2d 681 (3d Cir. 1982); Statement of Basis and Purpose, Cigarette Advertising and Labeling Rule, 1965, 29 Fed. Reg. 8325 (1954).

[62] The Supreme Court has recognized this principle in commercial speech cases. *Central Hudson Gas & Electric Co.* v. *PSC*, 447 U.S. 557, 567 (1980).

[63] *Fedders*, 85 F.T.C. 38, 61 (1975), petition dismissed, 529 F.2d 1398 (2d Cir.), *cert denied*, 429 U.S. 818 (1976).

[64] *See supra* note 27.

the unfair practices shown on this record, we adopt a requirement that cosigners be informed, prior to becoming obligated on a loan, of the nature of their liability (§ 444.3(a)(2) of the rule). To stem the deceptive practices demonstrated by the record, we impose a direct prohibition on misrepresentations of the nature or extent of cosigner liability (§ 444.3(a)(1) of the rule), and provide that compliance with the preventive requirement is sufficient to avoid charges that a creditor has engaged in misrepresentations in violation of the rule. To prevent both the unfair and deceptive cosigner practices, we require that a disclosure notice, the text of which is set out in § 444.3(b), be given to potential cosigners.

This scheme of remedial provisions is clearly within the Commission's authority. Section 18(a)(1)(B) provides that Commission rules "may include requirements prescribed for the purpose of preventing" acts or practices declared unfair or deceptive.[65] It is well established that the remedies selected by the Commission to cure the unfair or deceptive cosigner practices must bear a "reasonable relationship" to the practices demonstrated on the record. In *Jacob Siegel Co. v. FTC*,[66] the Supreme Court set forth the standard for review of remedial provisions of Commission adjudicative orders: "[T]he courts will not interfere except where the remedy selected has no reasonable relationship to the unlawful practices found to exist." The Supreme Court has reaffirmed the Commission's remedial discretion in adjudicative proceedings.[67]

The disclosure notice mandated by rule § 444.3(b) is intended to remedy the unfair and deceptive practices shown on the record by providing the potential cosigner with basic information about the nature and extent of cosigner liability. The notice is couched in general terms sufficient to alert

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[65] 15 U.S.C. 57a(a)(1)(B).

[66] 327 U.S. 608, 613 (1946).

[67] *FTC v. Ruberoid Co.*, 343 U.S. 470, 473 (1952); *FTC v. National Lead Co.*, 352 U.S. 419, 428-30 (1956).

consumers to the essential elements of cosigner status. Language such as "guarantee this debt" and "accept this responsibility" serves to make it clear that to be cosigner involves more than merely vouching for the primary debtor or serving as a reference. Language such as "full amount" and "fees or * * * costs which increase this amount" will make cosigners aware of the magnitude of the potential financial exposure they undertake. Language such as "same collection methods" and "*your* credit record" will alert the consumer to some of the additional potential consequences of cosigning a loan. Thus, this simple summary of the nature and extent of a cosigner's potential liability addresses the unfair practices of failing to disclose such information, as well as the deceptive practice of misrepresentation of the role of a cosigner.

Indeed, commenters endorsed the disclosure notice as necessary to remedy cosigners' lack of awareness of their liability and creditor misrepresentation of the nature of cosigner obligations.[68]

F. Alternatives Considered and Modifications Adopted

Because cosigners can be important in making credit available to consumers without a well established credit record, the rule as proposed did not ban their use. Instead, the rule originally proposed by the Commission would have imposed the following requirements:

1. Potential cosigners must be given a plain language explanation of their obligation.

2. Potential cosigners must be given a three day cooling-off period before they obligate themselves.

3. Cosigners must be given copies of all documents they sign or that are given to the principal debtor.

4. The contract obligating the cosigner must provide that:

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[68] Post-record comment summary at 159; 163, notes 44-45.

a. The creditor must employ "due diligence" in attempting to collect from the principal debtor before seeking payment from the cosigner.

b. The cosigner's liability is limited to the total of payments owed by the principal debtor at the time the cosigner becomes obligated.

c. The cosigner must be promptly notified of any default by the principal debtor.

During the preceeding, creditors emphasized the importance of cosigners in making credit available to inexperienced borrowers.[69] They argued that the rule provision would reduce the availability of credit to such borrowers if it made the use of cosigners costly or inconvenient. There was relatively little opposition to the concept of informing cosigners of their obligation.[70] There was strong opposition to the three day cooling-off period on the ground that it would cause serious inconvenience in making cosigner loans.[71] Creditors also

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[69] *E.g.*, D. L. Aldridge, Louisiana Independent Finance Association, R-II(1)-258; John A. Allgair, Jr., Manager, USARAL, Federal Credit Union, Ft. Richardson, Alaska, R-II(1)-316; F. H. Hamilton, Jr., President, People's Bank of Indianola, R-II(1)-387; Joe Martin, 1st United Bancorporation, Tr. 1165.

[70] *E.g.*, D. L. Aldridge, Louisiana Independent Finance Association, R-II(1)-258; Northrup Credit Union, Hawthorne, California, R-II(1)-342.

[71] Indeed, most objection to the proposed provision focused on the three day cooling-off requirement. *E.g.*, Paul H. Camerlengo, 1st City National Bank of Houston, R-I(a)-502; Ralph France, Bank of New Oreleand, R-I(a)-197; Helmut Schmidt, Transamerica Financial Corp., Tr. 6201; Alfred J. Lapan, South Middlesex Bank and Mass. Coop. Bank League, Tr. 11480; Gordon Wear, Texas Independent Automobile Dealer's Association, Tr. 715; James Goldberg, American Retail Federation, Tr. 8124; Richard C. Durham, Association Puertorriguena de Financieras Consumidor, R-I(a)-382; H. E. Smith, Alabama Lenders Association, R-I(a)-383; Larry G. Cardell, Sr., Merchant's National Bank of Allentown, Pa., R-II(1)-249. *See also*, Staff Report at 466; Presiding Officer's Report 285-286.

objected to the "due diligence" requirement, primarily on the ground that the term was ambiguous.[72]

Various objections were registered to the cosigner provision's application to open-end credit.[73] These concerns are addressed by providing that in open end transactions the disclosure notice be supplied only at the time of the initial extension of credit.[74] We have adopted modifications in that portion of the cosigner rule that we promulgate today to reach other concerns raised during the proceeding, such as paperwork burden.

The Final Rule

Although the record before us documents certain problems in connection with the use of cosigners, and although the Staff Report [7778] recommended a number of modifications in the rule provision initially proposed by the Commission, we are not persuaded that the benefits of those proposals

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[72] Gene L. Jamerson, 1st International Bancshares, Texas, R-II(a)-17; Melvin Struthers, Morris Plan of Iowa, R-I(a)-878; J. G. Turner, U.S. National Bank of Oregon, R-II(a)-10; Alan M. Black, Pennsylvania, R-II(h)-107; Jay Buele, Northern Trust Co., Illinois, R-II(a)-27; W. A. Browning, 1st National Bank of Boulder, Colorado, R-II(f)-172; R.C. Smith, Georgia Bank and Trust Co., R-II(f)-178; John Ross, Third National Bank of Ashland, Texas, R-I(a)-521; David Wood, Dial Financial Corp., Tr. 4705; Clare A. Rollwagen, Minnesota Consumer Finance Conference, Tr. 3940; Jack W. Woodburn, Cleveland Trust, Ohio, R-II(1)-361; Marshall M. Taylor, Lillick, McHose and Charles, Attorneys, Los Angeles, R-II(1)-182. Some creditors also argued that the due diligence requirement was substantively too restrictive. *See* Staff Report at 472.

[73] Post record comment summary at 166-167 notes 55, 57-58.

[74] D. Dale Browning, Senior Vice President, Rocky Mountain B.A.C. Corp. (BankAmericard), R-II(1)-243; Michigan National Bank, Lansing, R-II(1)-271; Holland and Hart, Attorneys, Denver, Colorado, R-II(1)-348; Larry C. Ross, Assistant Counsel, Vickers Petroleum Corp., Wichita, Kansas, R-II(1)-442; Ronald J. Green, American Express, R-I(a)-601; William T. Gwennap, American Bankers Association, Tr. 12222; Ely Kuchel, National Retail Merchants Association, Tr. 9341; Carl Felsenfeld, Citicorp, New York, R-II(c)-74; C. Lee Peeler, Washington, D.C., R-II(1)-406. *But see* Ernest D. Stein, Bank Vice President, R-II(1)-434.

offset their probable costs.[75] The rule we adopt today, providing a cosigner disclosure, will go a long way toward remedying not only the major problem reflected on the record—lack of consumer awareness of the full significance of becoming a cosigner—but also some of the ancillary problems that are, to a large degree, also a function of cosigner awareness.

The rule corrects the problems of cosigner lack of information by requiring that a notice be provided alerting the consumer to the obligations and consequences of cosigning. A disclosure requirement received support from creditors[76] as well as consumer representatives.[77] Robert P. Shay stated that:

"* * *the high incidence of payment being demanded (from cosigners) lends support to those who would urge some form of disclosure* * *"(HX-494 at 60).

It is also supported by the Presiding Officer who concluded:

> "The record of this proceeding supports a requirement that cosigners in consumer credit transactions should be provided by the creditor with a clear and succinct statement of their potential liability."[78]

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[75] *See* discussion of rejected provisions in Chapter XII.

[76] *E.g.*, Leslie R. Butler, Consumer Bankers Association and First Pennsylvania Bank, Tr. 11582; Vernon Lemons, Jr., Texas Finance Institute, Tr. 1022; Carl W. Berg, American Marine Bank, Wa., R-II(d)-83; Lucy Caldwell, Ferro Nashville Employees Credit Union, R-II(d)-25; Don E. Wolf, York Bank and Trust Co., Pennsylvania, R-II(b)-104; T. J. Ryan, Albuquerque Bell Federal Credit Union, R-II(d)-5.

[77] *E.g.*, Robert H. Erwin, Legal Aid of Baltimore, Tr. 10028; Gayle C. Williams, Legal Aid Society of St. Louis, Tr. 4612; Pamela Piering, C.A.M.P. Consumer Action Project, Wa., Tr. 6677; Charles Hammond, Arlington County Dept. of Consumer Affairs, Virginia, R-II(b)-128; Lewis Taffer, Alliance for Consumer Progress, Pennsylvania, R-II(H)-1; Ronald A. Gall, Wisconsin Consumers League, Tr. 3976; James L. Sullivan, Director, Department of Consumer Affairs, Missouri, Tr. 4581.

[78] Presiding Officer's Report at p. 285.

Compliance

This rule does not require that the creditor personally give the notice to the cosigner, but only that it "be given" to the cosigner. Therefore, if the creditor would not otherwise have personal contact with the cosigner, the rule will not require such contact. The creditor can provide the notice through the borrower or by other means such as the mail. However, the creditor is obligated by the rule to assure that the cosigner does *in fact* receive the notice prior to becoming obligated. If the creditor asks the borrower to give the notice to the cosigner and the borrower does not do so, the creditor will be in violation of the rule. Each creditor may adopt procedures of its own choosing for assuring that the notice is actually received.

The rule specifically requires that the notice be provided in a separate document. The purpose of this requirement is to assure that the cosigner will actually be aware of the notice before becoming obligated. Thus, the notice document cannot be affixed to other documents unless the notice document appears before any other document in a package, and it may not include any other statements, with one exception. Several states already require special notices to cosigners.[79] Those states may apply for an exemption under § 444.5 of the rule. However, if a state does not apply, or if an exception is not granted, a creditor can still avoid having to provide two separate documents by putting both notices in one, unless the state law forbids it.

Although this is not specifically addressed in the text of the rule, the Commission intends that the notice document may also contain the creditor's letterhead. The information on the letterhead would not distract the cosigner from the notice and, because the notice may very often be the only document retained by the cosigner, such information might prove helpful at a later time. Similarly, if a creditor chooses to assure cosigners obtain the disclosure documents by requesting a

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[79] *E.g.*, Section 422.305 Wisc. Stat. *See also* R-XIII-31 at C-28.

signed acknowledgement, the notice document may include a signature line.

We also note that the cosigner disclosure should be provided in the same language as that in which the underlying loan contract is written. Although this issue is not specifically addressed by the rule itself, failure to provide such same-language disclosures could constitute a separate violation of Section 5.

Open End Credit

Witnesses objected to the cosigner provision in open end credit transactions. They argued that the rule would require a notice upon each extension of credit pursuant to an open end account, making overdraft checking impossible and other forms of open end accounts complicated to administer.[80] The rule we promulgate today has been revised to make it clear that a notice need not be used every time a consumer draws on an open end line of credit.

For open end accounts, the cosigner need only be given a single notice at the time that the account is opened. The specific language required by § 444.3(b) of the rule has been modified so that it applies when the cosigner is guaranteeing an open end account and may be liable for an amount less than or equal to the line of credit extended.

Definition of Cosigner

Several creditors stated the rule can be evaded by requiring potential cosigners to become co-applicants for credit.[81] We incorporate in the final rule a revision which defines as a cosigner any person whose signature is obtained after the initial applicant is told that the signature of another person is necessary. Creditors should not seek to evade the rule by designating cosigners as co-applicants.

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[80] *See supra* note 74.

[81] Paul H. Camerlengo, First City National Bank of Houston, R-II(1)-236; Michael Brown, United Auto Dealers Association, Chicago, Tr. 2768-2768.

It was thought by some that the definition of cosigner was so broad as to include the principal debtor or an authorized user of a credit card.[82] Recommendations were also made that "compensation" be defined,[83] or that consideration[84] or some other term[85] be used in the definition. Substitution of the term "accommodation party" for cosigner was recommended, as was revising the definition to make it explicit that one who signs in order that another may receive the benefit of the goods or money is a cosigner.[86] It was also suggested that the definition does not make clear whether a person who hypothecates security of a passbook on a loan but does not personally guarantee the loan is a cosigner for the purposes of [7779] the rule.[87] One commenter thought that the definition should be modified by the addition of the phrase "whether or not that person is specifically designated on the contract as being a cosigner."[88] Another felt that cosigner should be redefined

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[82] Technical comments by the staff of the Board of Governors of the Federal Reserve Board, HX 451 at 16; William B. Johnson, Sun Oil Company, R-II(1)-466; Russell A. Freeman, Security Pacific Corp., Los Angeles, R-II(1)-339; James Goldbert, American Retail Federation, Tr. 8123.

[83] Technical comments by the staff of the Board of Governors of the Federal Reserve Bank, HX 451 at 18; Frederick T. Berhanka, Administrator Colorado U.C.C.C., HX 251 at 7; Thomas Crandall, Gonzaga University Law School, Wa., Tr. 10672-73; Bryce A. Baggett, Oklahoma Consumer Finance Association, Tr. 850.

[84] George H. Braasch, Chairman, Subcommittee of the Committee on the Regulation of Consumer Credit—Section of Corporation, Banking and Business Law of the American Bar Association, R-II(1)-325; David H. Pohl, Capital Financial Services, Ohio, R-I(a)-541.

[85] T. McLean Griffin, First National Bank of Boston, R-II(d)-54 would define cosigner as "a natural person who without compensation and without an opportunity to obtain credit under the obligation, * * * ."

[86] John P. Winston and Walter E. Huizenga, National Automobile Dealers Association, R-I(a)-551; Lois J. Wood, Land of Lincoln Legal Assistance Foundation, R-I(c)-361).

[87] Jack W. Woodburn, Cleveland Trust, Ohio, R-II(1)-361.

[88] Lois J. Wood, Land of Lincoln Legal Assistance Foundation, R-II(1)-438.

as one who renders himself "secondarily" liable for the obligation of another.[89]

We have adopted definitional revisions which accommodate these suggestions. The phrase "another person" will avoid confusion between a cosigner and a principal debtor. Clarifying language has been added defining a cosigner as one who enables a consumer to receive goods, services or money, but does not receive such goods, services or money himself.

We reject the recommendation that "consideration" be substituted for "compensation" since applicable cases hold that cosigner agreements are supported by consideration.[90] The use of the term consideration thus would not serve the purpose intended.

We have added language which makes it clear that a person is a "cosigner" under this rule, whatever he or she is called by a creditor, if he or she meets the definition in the rule.[91]

Modifications to Required Notice

The proposed rule requires use of a notice advising cosigners of their liability. The industry asserted that the originally proposed notice was too long, unclear, inconsistent with state and federal law, inconsistent with cosigner's rights [sic] under other parts of the rule, inapplicable to openend credit, and unnecessarily time consuming because of all the blanks to be filled in.[92] Some commenters felt that other information,

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[89] Betty Gregg, Credit Union National Association, Tr. 9674.

[90] *E.g., Zimmerman Ford, Inc.* v. *Cheney*, 271 N.E.2d 682 (Ill. App. 1971).

[91] Experience from Illinois, which has a cosigner statute, shows that enforcement has been prevented by disputes over the status of alleged cosigners, where creditors style cosigners as co-applicants. Lois J. Wood, R-II(a)-393.

[92] David J. Tarpley, Legal Services of Nashville and Middle Tennessee, Inc., Tr. 3670; Leslie R. Butler, Consumer Bankers Association and 1st Pennsylvania Bank, Tr. 11582; Colin K. Kaufman, Harvard Law School, Cambridge, Mass., R-II(f)-309, R-II(l)-364; Fred K. Harvey, Georgia Industrial Loan Association, Tr. 4470; James C. Barr, National Association of

especially the fact that the cosigner is being asked to take a risk which the creditor is unwilling to take, should be included in the notice.[93] We have adopted revisions as set out below to meet some of these concerns.

The notice as originally proposed had eight blanks which the creditor would be required to complete. The revised form has none. It is substantially shorter. The detailed recitation of remedies which a creditor could employ against the cosigner has been eliminated since some remedies are not available in all states.

The reference to the contract evidencing the obligation in the final paragraph has been amended to make it clear that it is the contract, and not the notice, which defines the cosigner's obligation.

Finally, Commission action in deleting the non-disclosure portions of the rule removes the possibility of a direct, albeit minor, conflict with certain state laws. A number of states already require informational notices to cosigners whose wording differs from the cosigner notice required by the rule. Because the state notices describe cosigners' obligations under existing law, they might no longer have been strictly accurate if the Commission adopted the parts of the proposed rule which would have substantively altered cosigner obligations.

Federal Credit Unions, Washington, D.C., R-II(l)-337; T.J. Hughes, Navy Federal Credit Union, Washington, D.C., R-II(l)-394; Russell A. Freeman, Security Pacific Corp., Los Angeles, Ca., R-II(l)-339; Jack W. Woodburn, Cleveland Trust, Ohio, R-II(l)-361; Robert W. Fox, Atlantic Federal Savings and Loan Association, Florida, R-II(a)-1; William T. Gwennep, American Bankers Association, Tr. 12222; T.J. Ryan, Albuquerque Bell Federal Credit Union, R-II(d)-5.

[93] A.B. Calvin, Dyche, Wright, Sullivan, Bailey and King, Tx., R-II(l)-289; Charles W. Noble, Metropolitan National Bank, Tx., R-II(l)-232; David K. Krump, Grant County State Bank, Ulysses, Kansas, R-II(l)-139.

X. Analysis or Projected Costs, Benefits, and Effects of the Rule

As set forth earlier, the Rule comprises six major components—four contract clauses that are prohibited, one accounting practice that is prohibited, and an affirmative disclosure requirement. Each of these elements is, to a certain extent, segregable from the whole for the purposes of analyzing projected costs, benefits, and effects of the rule.

However, many of the projected costs and, to a lesser extent, benefits of the rule may not be readily segregable, and therefore are more appropriately attributable to the rule as a whole, rather than to any particular element of the rule. These benefits and costs are likely to arise from the impact on the market of the entire rule, rather than from the impact of any one element.

The costs and benefits attributable to the individual provisions of the rule are discussed in Chapters IV-IX, *supra*. The costs and benefits of the interrelated parts of the rule as a whole are discussed here.

A. Costs

Most commenters who opposed the rule argued that it would increase credit costs by either increasing the price of credit (because consumers would demand more of a more attractive product and creditors would supply less of it) and/or decreasing the availability of credit, especially for the marginal risks (because of stricter screening of credit applicants). These commenters stated that such increases in costs to creditors would outweigh whatever benefits consumers and competition might obtain from the rule. The record for the proceeding establishes, however, that the rule will not have a major impact on either the price or availablity of credit.

1. Econometric Studies

Comprehensive econometric analyses of creditor remedies, interest rates, and amount of credit extended were prepared

for the rulemaking record. The results of these studies were consistent with the experience in the states, described below.

The first study was a detailed and thorough examination of the theoretical economic implications of the rule and the empirical work carried out by the National Commission on Consumer Finance that evaluated these implications with reference to the existing consumer credit market.[1] This study defined the economic issues raised by the rule, evaluated the empirical work that predated it, defined a microeconomic model of the consumer credit market, and suggested further empirical work in the area to answer the fundamental questions about the effects of restrictions on creditors' remedies on credit cost and availability.

The report contains a variety of important conclusions based on an examination of the data bases compiled by the technical staff of the National Commission on Consumer Finance. It found, for example, that there is no significant relationship between interest rate ceilings and rejection rates. It also found no significant relationship between prohibition of creditor remedies and rejection rates.[2] In short, **[7780]** there appeared to be no significant correlation between permissible creditor remedies and creditor willingness to extend credit to consumers.

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[1] The results are found in R-XI-10, *Federal Trade Commission Proposals for Credit Contract Regulations and the Availability of Consumer Credit*, Michael Aho, James Barth, Joseph Cardes, Anthony Yezer, Daniel Brumbaugh (May 20, 1976).

[2] R-XI-10 at 90-93. These data were drawn from finance company loans in 47 states. The sample included Arkansas, which had a uniquely low interst rate ceiling. The study eliminated Arkansas from its computations because there are no finance companies in the state. The NCCF simply postulated a 100 percent rejection rate for the state. No one disputed the effects of Arkansas' 10 percent rate ceiling on consumer loans. This ceiling was an aberration and was raised to 24 percent by the voters of Arkansas in 1982.

In a second study,[3] Professors Barth and Yezer developed a simultaneous econometric model for the consumer credit market. This model relies on individual, discreet loan transactions. Having developed the model, Barth and Yezer ran three series of regressions using data obtained from FTC investigations and data obtained from the National Consumer Finance Association.

Early problems with compiling an accurate table of state laws[4] were eliminated in later versions of the study, which were presented in hearings on the rule.[5] Using different data bases after problems with the state law data were eliminated, Barth and Yezer achieved consistent results. During the hearings, the NCFA introduced a large data base covering thousands of recent consumer loans. Barth and Yezer ran a final version of their study using this data base.[6]

In their final study, Professors Barth and Yezer concluded that the percentage point estimate for the rule's effect is a 19/100's of 1 percent (0.192%) increase in credit costs. Even this estimate may be too high because it compares a hypothetical laissez-faire state having *no* remedy restrictions with the same state having nearly all of the originally proposed restrictions. As noted, we have determined not to adopt several of the original staff recommendations, and we have significantly modified and refined several of those which we do adopt.

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[3] The results are found in R-XI-161, *The Economic Impact of the Federal Trade Commission Proposals for Credit Contract Regulations on the Cost and Availability of Consumer Credit* (March 31, 1977). The studies excluded evaluation of waivers of exemption and cosigner provisions.

[4] An evaluation of state laws is essential for developing creditor remedy variables. Thus, the empirical results reported in R-XI-161 are invalid. The later results, using accurate state law data, are found at HX-505 (FTC data) and R-XIII-39 (NCFA data).

[5] *See* HX-505.

[6] R-XIII-39.

Although the specific point estimates with respect to the impact of the rule on credit cost should be viewed as indicating a range or order of magnitude and not a precise estimate, the Barth-Yezer studies demonstrate that the impact of the rule on credit cost will be "clearly negligible."[7]

During the course of this proceeding, the econometric studies—in particular the Barth-Yezer studies[8] —were the subject of considerable scrutiny and critical analysis.[9] The Commission looked closely at the overall economic evidence, and focused on the Barth-Yezer work, during our final deliberations on the rule.[10] We are cognizant of the limitations of the econometric studies. The studies represent, however, the most sophisticated analyses available on the record.[11]

We have given careful consideration to the econometric evidence assembled on this record, particularly the latter studies of Professors Barth and Yezer. Our review has led us to consider that the econometric evidence does not, of itself, permit a definitive finding concerning the net costs or benefits of the rule as a whole. The relatively small magnitude of effects indicated by the econometric evidence does permit us to be reasonably certain that the effect of the rule will not be unduly large in either direction. Our conclusion in this regard

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[7] R-XII-39 at 7. Examination of the Barth/Yezer regressions using FTC and NCFA data reveals that the impact of individual provisions of the rule on credit cost is not significantly different from zero. Barth and Yezer consider that all the remedy variables must be viewed together, and that the study demonstrates that individual remedies cannot be evaluated except as a group.

[8] *See supra* notes 5-6.

[9] *See, e.g.*, NCFA Comments, R-XV-343 at 54-58; *see also* memorandum of April 4, 1983 from Timothy J. Muris, Director, Bureau of Consumer Protection, at 18-24; memoranda of the Bureau of Economics, April 5 and 7, 1983.

[10] Professors Barth and Yezer made oral presentations before the Commission and were questioned by the Commissioners. *See* "Oral Presentations by Public Representatives," June 6, 1983, Tr. 91-121.

[11] *See, e.g.*, Muris memorandum, *supra* note 9 at 24, *citing* Staff Report at 527-39.

has led us to look more closely at the other available evidence on the rule as a whole and as to each provision.

2. Experience in the States

There exists a large body of experience with restrictions on creditor remedies in consumer transactions. Most states already have laws similar to one or more of the provisions of the rule. During the rulemaking proceeding, three states were identified that have legal regimes comparable to (or stricter than) the rule as it was then proposed.[12]

State experience was examined intensely during the rulemaking proceedings. Statistics on credit markets in different states were submitted by NCFA, state regulators, and other sources. Comparisons were made between market conditions in states with laws similar to the proposed rule and other states.[13] Although there is some state to state variation, these comparisons reveal no systematic differences between states that have restricted remedies and the other states. Interest rates in reform states tend to be lower than in representative states that do not restrict remedies covered by the rule.[14] Borrower income and default rates were lower in reform states than in non-reform states, while borrower debt levels tend [sic] to be higher. Overall, there are no apparent negative impacts on cost where credit reform laws have been enacted.

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[12] Wisconsin, Iowa and Connecticut. Because the final rule has deleted a significant number of the initial proposals, a larger number of states could now be said to have existing restrictions similar to the final rule.

[13] See especially Staff Report at 525. *See also* Staff Report at 546 note 177, and 517; R-XIII-36 (state by state breakdown of NCFA survey data). Most of these comparisons used NCFA data on finance company loans. Finance company loans are the market segment where adverse effects of the rule would be most apparent because finance companies deal with higher risk borrowers and make greater use of these remedies than do other creditors.

[14] *See* "Comparison of Precomputed Loan Account Characteristics, Selected States," Staff Report at 525.

Another source of information on state experience is comments and testimony by state regulators, creditors, and other persons from states that have adopted laws similar to the rule. In some instances these individuals accompanied their testimony with statistics, for example, on market conditions before and after a credit reform law took effect. [15] Although occasional negative effects were noted, [16] the consensus was that the state reform laws had not interfered with creditors' business. [17] No significant [7781] effect on the cost or availability of credit was reported.[18] Creditors, for example, testified that they lent to the same type of consumers and applied the same credit standards after reform laws were passed as before.[19] Other testimony from the three "laboratory" states was consistent with these observations.

3. Other Evidence on Effects on Costs

The record also contains extensive evidence on the value of individual remedies to creditors. From this evidence we have drawn general inferences concerning the cost to creditors (and thus ultimately to consumers) of banning remedies. All

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[15] Testimony by these witnesses is summarized in detail in the Staff Report at 501-522.

[16] *E.g.*, Clarence P. Bleser, Wisconsin Finance Corp., Tr. 3481-83 (*but see* Robert P. Shay, HX-494 at 24); Thomas H. Huston, Iowa Banking Dept., Tr. 2289-91 (reports small increase in collection cost primarily attributable to an Iowa law provision not contained in rule). *See also* discussion of Credit Research Center Studies of Wisconsin Consumer Act in Staff Report at 544-548.

[17] *E.g.*, Richard A. Victor, Wisconsin Department of Justice, Tr. 4016-17; Robert A. Patrick, Office of Wisconsin Commissioner of Banking, Tr. 4037-38, 4044, R-I(d)-109 at 1; Tucker K. Trautman, Colorado Dept. of Law, HX-252 at 3; Edward J. Heiser, Jr., Wisconsin Consumer Finance Ass'n, Tr. 3447; James L. Brown, University of Wisconsin, HX-153 at 1-3; Robert C. Focht, Connecticut Banking Dept., Tr. 11252; Diane Cadrain, Connecticut Citizen Research Group, Tr. 10805; Kathleen Keest, Blackhawk County Legal Aid Society, Tr. 4267. *See also* Presiding Officer's Report at 340.

[18] *Id.*

[19] *E.g.*, Clarence P. Bleser, Wisconsin Finance Corp., Tr. 3481-, 3491-92; Thomas H. Huston, Iowa Banking Dept., Tr. 2289-90.

of the remedies addressed by the rule are ones whose importance to creditors is limited.[20] Evidence on the value of each remedy covered by the rule is reviewed in the respective chapter on individual rule provisions.[21] Some examples will illustrate the types of information on which our conclusions are based.

Several important types of evidence on value of remedies relate to all rule provisions. Evidence on causes of default, discussed in Chapter III above, is one example. Another is survey evidence on the importance of various collection methods to creditors.[22] The most important remedies—garnishment, repossession, acceleration of the debt, suit, and direct contacts with debtors—are not restricted by the rule.

The evidence establishing the limited value of the remedies covered by the rule helps to explain the finding that state laws restricting remedies have not had significant disruptive effects on credit markets. It also provides an independent reason for concluding that the rule also will not have such effects.

B. Benefits

A key issue throughout the rulemaking proceeding has been whether the benefits received by consumers from

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[20] Throughout this proceeding, the rule has been revised, modified, and otherwise narrowed to leave intact those remedies demonstrated to be of greatest value to creditors. The original April 19, 1974, staff memorandum recommending the rule excluded self-help repossession from the proposal in part because of its importance to creditors. During the proceeding the staff recommended revisions in the rule so as not to interfere with non-household goods security interests and non-pyramided late fees and extension charges. *See* Staff Report at 244-245 and 364-366. We have further narrowed the household goods provision. Finally, we deleted provisions covering third-party contacts, deficiencies, attorneys' fees, cross-collateral clauses, and substantive regulation of cosigners.

[21] *See* the chapter subsections on "Offsetting benefits."

[22] *See* Staff Report at 494-495 discussing National Commission on Consumer Finance survey results.

restricting one or more of these remedies would offset any decrease in credit availability or increase in credit costs that may result. Although many of the benefits of the rule are properly addressed in the context of the individual provisions, a general overview can be made.

Because default is largely beyond the debtor's control, the benefits of the proposed restrictions would be potentially available to any consumer. No one is so free from the possibility of loss of employment, large medical expenses, marital discord, etc., that the rule might never provide benefit. The benefits to all consumers can thus be analogized to insurance, in some respects.[23]

Many of the rule's benefits are difficult to evaluate monetarily, such as: procedural due process protections; the opportunity to assert valid claims and defenses; less economic distress and disruption of family finances; less embarrassment, humiliation, and anxiety; less interference in employment relations; retaining personal possessions and household goods; protection against coerced settlements; and well informed cosigners. Nonetheless, consumers place a value on such benefits (*e.g.*, less emotional distress). Their willingness to pay for contracts that reduce these possibilities is the measure of these benefits.[24]

Other benefits are more susceptible to an estimate of monetary value for individual consumers. These benefits include: fewer costly refinancings; less loss of equity in property; goods remaining in the hands of the party who values them more

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[23] *See supra* Chapter II.

[24] In their second economic study for this proceeding, Professors Barth and Yezer assessed the rule's potential benefits by calculating consumers' willingness to pay higher rates for contracts with fewer creditor remedies. The study concluded that consumers were willing to pay up to an additional 7.18 percent APR for more favorable contract terms. This study was based on FTC-supplied data, an admittedly unsound data base. The last study, using NCFA supplied data, did not estimate consumers' willingness to pay. No other evidence measured this factor.

highly; and fewer additional delinquencies "triggered" by one creditor filing a wage assignment.

C. Summary

In assessing the costs and benefits of this rule, the Commission must be guided by ranges and magnitudes and not precise dollar estimates. There is no means available to prepare precise, dollar point estimates of the costs and benefits of curtailment of creditors' remedies. This is because these costs and benefits are small, when factored into any precise empirical model that endeavors to define the array of factors which influence credit extension decisions. Moreover, the rule does not affect the most valuable creditor remedies, including garnishment, self-help repossession, direct debtor contacts and the like. Nor does our final rule address several creditor remedies encompassed in the original proposal (and upon which all aggregate impact assessments are based), *e.g.*, deficiencies, attorneys' fees, etc.

Although any restrictions on creditor remedies have cost implications, factors other than these six remedies predominantly determine costs and availability. The most important factors are: (1) The cost of money to the creditor, (2) the consumer's present income, existing debt level, and capacity to incur further debt, (3) the possibility of the consumer being a repeat customer, (4) the creditor's opportunity costs, (5) the applicable interest rate ceilings, (6) the availability of other fees and charges, (7) the availability of the most useful creditor remedies, (8) the principal amount of the loan, etc. Aggregate economic conditions have an effect as well. Thus, any assessment of the rule's potential effects on credit costs or availability must start from a position that the remedies involved have little effect relative to the major determinants of cost and supply. Although this is not, in itself, evidence of the net effect of the rule, it does provide a context for assessing the expected impact of individual rule provisions, discussed in relevant chapters above.

The benefits of this rule also cannot be quantified precisely. At issue is the treatment of borrowers and their families when serious financial problems occur. The record contains extensive evidence that the specific remedies at issue here are a direct cause of substantial consumer injury, that consumers cannot reasonably avoid such injury, and that the injury is not offset by other benefits, either to consumers or to competition. The record contains evidence of the use of challenged remedies and the effect of such use on consumers and their families. Much of this evidence is quantitative in nature.

XI. Impact on Small Business

In the course of this proceeding certain creditors argued that the rule will injure small businesses.[1] Our review [7782] of the record reveals no disproportionate impact on small business from federal or state credit reforms. To the contrary, Federal Reserve Board data compiled by the NCFA show that the number of small finance companies grew from 1970 to 1975, notwithstanding increasing competition from banks and credit unions, the Supreme Court's decisions in *Fuentes* v. *Shevin*[2] and *Sniadach* v. *Family Finance Corporation*,[3] and passage of the Consumer Credit Protection Act of 1967 (which includes, as amended, Truth in Lending, Equal Credit

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[1] *See, e.g.*, Thomas Rothwell, National Small Business Association, HX-430; Leonard M. Cohen, Independent Finance Association of Illinois, Tr. 2477; Robert E. Dean, Security Mutual Finance Corp., Tr. 161; William Lehye, Consumer Loan Co., Tr. 4361; Gary Finn, Summit Federal Credit Union, R-I(a)-17; George Jones, Louisiana Independent Tire Dealers Association, R-I(a)-288; G. C. Backhaus, Post Finance Company, R-I(a)-796; Richard Warren, Alabama Lenders Association, R-I(a)-361.

[2] 407 U.S. 87 (1972).

[3] 396 U.S. 337 (1969).

Opportunity, Fair Credit Reporting, and other credit reforms).[4]

[4] Relevant data are summarized in the following table:

NUMBER OF FINANCE COMPANIES BY SIZE, JUNE 30, 1960, 1965, 1970, AND 1975

	1960	1965	1970	1975
Companies having short- and intermediate-term credit outstanding of:				
Under $100,000	2,124	1,199	826	863
$100,000 to $499,999	2,770	1,771	1,065	1,204
$500,000 to $999,999	652	535	424	416
$1,000,000 to $4,999,999	631	498	399	500
$5,000,000 to $24,999,999	175	164	112	204
$25,000,000 to $99,999,999	46	82	77	103
$100,000,000 and over	27	44	58	88
Total	6,424	4,293	2,961	3,376

Source: National Consumer Finance Association, *Finance Facts Yearbook* (1978 ed.) at 52.

The distribution of the number of finance companies by dollar amounts outstanding in the years 1960, 1965, 1970 and 1975 indicates sharp decreases in the number of very small firms (less than $1 million in outstanding) from 1960 through 1970, followed by a 7 percent increase in their total number during 1970-75 — the time period in which the most significant federal and state consumer credit reforms took effect (Truth in Lending became effective in the second half of 1969). While the number of firms in the $500,000-$999,000 category decreased slightly from 424 in 1970 to 415 in 1975, this may mask upward movement in individual firms' total outstandings because the $1,000,000-$4,999,999 category grew from 399 to 500 firms in this period.

The total number of finance companies increased from 2,961 in 1970 to 3,376 in 1975. Of these 3,376 firms, the top 88 (outstandings of $100 million and over) operated 18,899 offices, an average of 215 offices per firm. The remaining 7,985 offices in the total industry were distributed among 3,288 firms with outstandings under $100 million, an average 2.4 offices per firm. National Consumer Finance Association, *Finance Facts Yearbook* (1978 ed.) at 52. At this level, many of the firms with 5,000,000-24,999,999 outstanding probably can be considered "small business" in this category between 1970 and 1975 suggests that consumer credit reforms have not disproportionately affected small- to mid-sized businesses.

More specifically, with respect to this rule the record contains evidence that many small creditors need to rely less on the contractual provisions and non-contractual practices addressed by the rule than large multi-office firms. Several operators of one and two office finance companies testified on their strong community ties, histories of courteous personal service to successive generations of related customers, and effective "notice and phone call" collection programs. [5] Thus, small finance companies tend to rely less on the practices addressed in the final rule.

On the other hand, major national finance chains have high turnover rates in office personnel, uniform procedures for handling minor delinquencies and serious defaults, and generally deal with their customers on a less personal basis than small independents. [6] The more personalized approach to collections that is possible for smaller creditors in many cases can serve as an effective substitute for formal remedies.

The National Commission on Consumer Finance survey results suggest that smaller banks and single-state retailers and finance companies tend to be less dependent upon many

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[5] William Lehye, Consumer Loan Co., Tr. 4356-62 (" * * * since I have been in the business for 36 years, I can look a guy in the eye and make a loan. But, if you take a chain organization or bank where you have never met this fellow before and you have not been in the community for 33 years and you are learning to be a loan manager, there is no way that chains or anyone else other than small business like myself can make it on character alone."); Al Brandt, Brandt Finance Company, Tr. 7516-16; H. E. Smith, First Finance Company, Tr. 2950-51; William Probasco, Mid Valley Time Loan, Tr. 6128-29; Ray Houghton, Home Finance Corp., Tr. 6624; Joseph Park, Community Finance Co., Tr. 3189; Bernard Cunningham, Windsor Locks Finance, Tr. 8572-73; James Hassenger, Citizens Loan and Thrift Company, Tr. 3621.

[6] *See generally*, subpoenaed finance company consumer files operating manuals and employee training materials in R-XI. G. Benston, *The Costs to Consumer Finance Companies of Extending Consumer Credit*, NCCF Technical Studies Vol. II at 8 (labor turnover averages about 80 percent per year for most companies).

of the contractual provisions and practices affected by the rule than larger firms.[7]

While there has been a long-term declining trend in the role of small finance companies this trend is attributable to causes other than regulations on creditor remedies.[8] The record, taken as a whole, does not indicate that the rule will have a disproportionate effect on smaller creditors.

XII. Relation Between The Rule and State Law

The rule has been drafted to be as consistent with existing state laws as possible. Indeed, state laws served as the model for several rule provisions. The rule prohibits practices that are authorized by statute or common law in at least some states. However, none of the rule provisions *preempts* state

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[7] *See*, National Commission on Consumer Finance, *Technical Studies*, Vol. V at 72-73 (banks, finance companies, and retailers' use of security interest and repossession provisions); 79-83 (banks and finance companies' use of deficiency judgments).

Two remedies prohibited by the rule, wage assignments and confessions of judgment, tend to be included more frequently in the form contacts of single-state (compared to multi-state) finance companies and retailers. *Id.* at 53-55, 65-66. This result may be explained in part by the widespread state restrictions imposed upon these remedies which necessarily limit their importance to any company operating on a national scale. The frequency of inclusion of these two remedies in bank contracts did not differ significantly between large and small banks in the NCCF survey. *Id.* at 51, 64. Another reason for this phenomenon may be that smaller creditors cannot afford more expensive, formal collection methods.

[8] Paul Smith, Vice Dean of the Wharton School, identified bank commercial loan interest rates as "the most important" source of difficulty for small finance companies. Tr. 8494. By the same token, Dr. Smith pointed out that large finance companies are able to obtain capital at lower rates than small firms. Tr. 8495. He also stated that increasing competition from banks and credit unions and economies-of-scale in large, multi-branch operations have contributed to decreases in the number of independent firms. Tr. 8494-95. In his testimony, Dr. Smith did not allege that regulatory restraints have figured in this trend. *See also*, Robert C. Focht, Connecticut Banking Department, Tr. 11266-69.

law by creating an irreconcilable conflict. That is, creditors will be able to comply with both state law and this rule.[1]

Under the law governing preemption, state legislation that imposes requirements not inconsistent with the rule will remain in effect, whether or not states seek exemption. Therefore, where state regulation is more stringent than the rule, compliance with the rule will not immunize creditors from state [7783] requirements.[2] We have, however, adopted a provision (Section 444.5) that affords an opportunity for states whose laws are substantially equivalent to, or more protective than, the rule to apply for specific exemption from the rule. This provision can be invoked with respect to any provision of the rule, but we are particularly mindful of the states' role in defining what items are considered necessities, in the context of the rule's household goods definition.

Under §444.5, the rule will not be in effect in a state to the extent specified by the Commission only if: (1) Application for an exemption is made by a state; (2) there is a state requirement or prohibition[3] in effect that applies to any transaction to which a rule provision applies; and (3) the state shows that its provision provides a level of protection that is as great as, or greater than, the protection afforded by the

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[1] FTC rules only preempt state law where there is a direct conflict. See, *e.g.*, Statement by the Commission in *Hearings on S. 986*, 92d Cong., 1st Sess. 65 (1971) at 15; *Florida Lime & Avocado Growers, Inc.* v. *Paul*, 373 U.S. 132, 141 (1963). *Florida Lime* held that for Federal law to preempt there must be "such actual conflict between the two schemes of regulation that both cannot stand in the same area," or "evidence of a congressional design to preempt the field." No evidence of a design to preempt the field of creditor remedy regulation is present in either the Federal Trade Commission Act or the rule.

[2] *See, Mobil Oil Corp.* v. *Attorney General*, 380 N.E.2d 408 (Mass. 1972) in which the court held that a state statute banning certain promotional games of chance was not preempted by a Federal Trade Commission rule regulating such games.

[3] For purposes of this rule, a state requirement or prohibition could include statutes and formal state regulations. It would not include informal enforcement policy statements.

rule provision. If an exemption is granted, it shall be in effect only for as long as the state administers and enforces the state provision effectively.

As set forth in §444.5, the Commission will determine the appropriate relationship between the rule provisions and state provision on a case-by-case basis in the context of an exemption proceeding conducted pursuant to §1.16 of the Commission's Rule of Practice. The Commission will evaluate appropriate petitions for exemption made by state governmental agencies to determine the level of protection to consumers and whether the state regulation is administered and enforced effectively.

The requirement in §444.5 that a comparable state requirement be "substantially equivalent" to the Commission rule provision does not, in our view, require that the state requirement mirror exactly the Commission provision. Any differences that exist, however, should be minor so as not to deprive consumers of the level of protection guaranteed by the Commission rule nor to complicate significantly compliance by interstate creditors.[4] Other factors that will be considered by the Commission in determining whether an exemption is warranted include the resources committed by the state to enforce its provisions, and the extent of any private rights of action available to aggrieved consumers.

Only state governmental entities may request exemptions from provisions of the Commission's rule under §444.5. The grant of an exemption based on state requirement will necessarily place on the state the primary burden to enforce its provision. Therefore, a decision to seek exemption should be made solely by the state entity involved.

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[4] The standard is analogous to that applied by the Federal Reserve Board in determining state exemptions from requirements of the Truth in Lending Act. *See* Board of Governors of the Federal Reserve System, Consumer Leasing, Truth in Lending; Exemption Application * * * , 47 FR 16210, April 15, 1982.

In a number of instances, participants in the proceeding indicated that the rule might conflict with state law, or interact with state law in a confusing or unforeseen way. We have adopted modifications in the rule to eliminate these problems.[5]

In response to concern expressed by state officials[6] and others,[7] the Commission takes this opportunity to make clear that the rule is not intended to occupy the field of credit

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[5] For example, we have excluded certain wage assignments from Section (a)(3) of the rule because of possible problems with the California Personal Property Brokers law, clarified Section (a)(2) on waivers of exemption to avoid problems with mortgage laws in certain states, and significantly scaled back § 444.3 on late fees in such a way as to avoid conflict with state laws on late fees. See generally the sections of this Statement on individual rule provisions.

[6] *E.g.*, Tucker Trautman, Colorado Assistant Attorney General, HS-252 at 3-12; Richard Gross, Massachusetts Assistant Attorney General, Tr. 10926; Richard Victor, Wisconsin Assistant Attorney General, HX-151; Robert Patrick, General Counsel, Wisconsin Office of Commissioner of Banking, HX-152 at 8.

[7] *E.g.*, National Consumer Law Center, R-I(c)-103 at 10-11; Jonathan Epstein, Essex-Newark Legal Services, Tr. 8947; Michael Burns, Legal Aid Society of Minneapolis, HX-95 at 13; Terry Friedman, Western Center on Law and Poverty, Tr. 6537; Ronald Gull, Wisconsin Consumer League, Tr. 3976-77; Mary Gillespie, San Francisco Neighborhood Legal Assistance Foundation, Tr. 5588-89; James Brown for Consumer Affairs, University of Wisconsin Extension, HX-153 at 12. The Presiding Officer suggested that language should be added to the rule to eliminate conflicts with certain Federal laws or regulations. Presiding Officer's Report at 352. Examination of the testimony cited by the Presiding Officer in support of this recommendation does not reveal any specific conflicts between the rule and Federal law. Although there were no direct conflicts, witnesses were concerned about the relation between various Federal laws and the rule provisions on late charges, waivers of exemption, and restrictions on non-purchase money security interests. We have adopted modifications in these provisions that eliminate the concerns expressed. In particular we have substantially reduced the scope of the late fees provision, thereby avoiding problems with Federal late fees regulation, and have clarified the waivers provision and modified the security interest provision so that they do not effect real property mortgages.

regulation or to preempt state law in the absence of requirements that are inconsistent with the rule.

XII. Empirical Evidence on the Benefits and Costs of Provisions Considered by the Commission But Not Adopted.

This section discusses the benefits and costs of provisions of the 1975 proposed rule that the Commission considered but did not accept, together with analysis of a disclosure alternative considered by the Commission during its final deliberations on the rule.

A. Deficiencies

A deficiency arises when repossessed collateral is sold for less than the amount owing on a debt. The Commission has considered but rejected a provision that would have required valuing collateral other than household goods at its retail price for purposes of calculating deficiencies. The provision would have required an election of remedies in the case of household goods collateral, requiring creditors to choose between repossession or suit.

1. Prevalence

Sizeable deficiencies occur in the majority of transactions involving automobile repossessions; average automobile deficiencies range from 25 to 50 percent of the balance owing at the time of default.[1] Little evidence addresses deficiencies for other types of collateral. Creditors apparently pursue a deficiency only infrequently, and on average creditors recover no

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[1] *E.g.*, Note, "Defaulting Debtors and the Judicial Process—The FTC's Proposed Restriction on Delinquency Judgments. Section 444.2(a)(7) of the Rule on Credit Practices," 8 Conn. L. Rev. 459, HX-338; Note, "Business as Usual: An Empirical Study of Automobile Deficiency Judgment Suits in the District of Columbia," 3 Conn. L. Rev. 511 (1971), R-XI-84; Shuchman, "Profit on Default: An Archival Study of Repossession and Resale," 22 Stan. L. Rev. 20 (1969), R-XI-85; Note, "I Can Get It For You Wholesale: The Lingering Problem of Automobile Deficiency Judgments," 27 Stan. L. Rev. 1081 (1975), HX-247; GMAC, R-I(a)-812 at 9-10; Bank of America, HX-227 at 6; Security Pacific National Bank, HX-204; Gwennap, HX-500 at Table 4; Milroy, Tr. 5486-87; Nagel, R-II(g)-64; Marsh, Tr. 2818.

more than 5 to 15 percent of the deficiency.[2] As the Presiding Officer noted, under these circumstances creditors have an incentive to obtain the best possible price, net of sales costs, for collateral.[3] There is, therefore, insufficient evidence that problems in the valuation of collateral are prevalent. **[7784]**

2. Benefits

The benefits of an election of remedies requirement in repossession of household goods would be similar in nature if not magnitude to those that would result from the provision to prohibit non-purchase money security interests in household goods. When a deficiency is pursued, a requirement for valuation at the retail price would benefit borrowers, because normally resale would take place at the lower wholesale value. In the event of abuse, resale may take place below wholesale value.

Retail valuation thus raises two issues. The first is the requirement to credit consumers with the retail rather than the wholesale value of repossessed collateral before pursuing a deficiency. The second involves any remaining problems in cases where consumers are credited with less than the wholesale value of the goods. These issues will be addressed before considering the benefits and costs of the provision.

The difference between retail and wholesale prices is a result of the costs of retailing. The Commission concluded that it is not unreasonable for defaulters to bear the costs of retailing repossessed collateral and that sales at wholesale prices are therefore not inherently unfair. When retailers sell repossessed collateral themselves, they normally do sell it on the retail market.[4]

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[2] *E.g.*, Schmidt, Tr. 6194; GMAC, R-I(a)-812 at 10; Brown, Tr. 2771; Martin, Tr. 1143, 1154-55; Marsh, Tr. 2819-20.

[3] Presiding Officer's Report at 250.

[4] *E.g.*, R-XI-167.

The fact that repossessed cars are sold for prices below wholesale book value[5] can often be explained by differences in the condition of repossessed cars and the average "good" used car,[6] and hence there is little basis for concluding that undervaluation of collateral is prevalent.

The record does, nevertheless, reveal some problems in valuation of collateral when the creditor and the buyer are closely related. When the creditor sells the car to itself or in a "sweetheart" deal, there is an incentive to undervalue it to the extent that recovery on a deficiency is possible. However, the evidence does not indicate that such undervaluations are prevalent,[7] and they frequently violate existing state law. The U.C.C. requires that collateral be disposed of in a "commercially reasonable" manner. As the Presiding Officer noted, a valuation requirement "is not a self-executing remedy. To secure benefits, consumers must resort to the courts just as they must do to insure that sales of collateral under current laws are made in a commercially reasonable manner. In view of reluctance or inability to take this action as shown by the record, the provision will be largely ineffective."[8] We therefore conclude that a case-by-case approach to enforce existing standards of valuation in the event of abuse is preferable to a rule that would restrict the legitimate use of deficiencies.

3. Costs

To the extent that these provisions would reduce recovery on deficiencies, or restrict repossession of household goods used as collateral for installment credit or purchase money loans, they would reduce the value of collateral to creditors and hence increase creditors' costs and losses due to defaults.

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[5] Note 1 *supra* at HX-338.

[6] *E.g.*, R-XI-71-77 and R-XI-70.

[7] Presiding Officer's Report at 248.

[8] Presiding Officer's Report at 249.

In addition, the determination of retail value and the allocation of selling costs would involve substantial costs for creditors as well as enforcement agencies.[9] These costs would be especially great if a vehicle required extensive repairs or was resold several times before its eventual retail disposition.

Furthermore, the retail value provision could create perverse incentives. Some debtors might intentionally default on their loans in order to obtain free retailing services, the costs of which would be imposed on creditors.[10] The rule would also create incentives for creditors to enter retailing even though costs might be lower if more efficient retailers were used.[11]

4. Commission Decision

A majority of the Commission decided that this provision would impose costs, and could raise the cost and reduce the availability of credit, in excess of offsetting benefits. Crediting debtors with the wholesale value is not unfair when a higher price is not obtained, there is little evidence of prevalence concerning valuation below the wholesale value, and such valuations are already illegal under current standards. Our decision is consistent with the Presiding Officer's findings concerning the retail value provision.[12]

B. Attorney's Fees

The Commission considered but rejected a provision prohibiting credit contract clauses requiring that debtors pay attorneys' fees incurred by creditor in debt collection.[13] This

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[9] *E.g.*, Friedman, Tr. 61-62; Breeden, Tr. 1400; Edwards, Tr. 8506; Boyle, Tr. 18-19; Fish, Tr. 522-23; Walthen, Tr. 2312; 2315-17; Martin, Tr. 1142; Warren, Tr. 8315-8316; NCLC, R-1(c)-103 at 41, 54; NCLC, R-XIII-40 at 153.

[10] *E.g.*, Brown, Tr. 2772-73; Carner, Tr. 1498-99.

[11] Bureau of Economics, "Comments on Credit Practices Rule," August 18, 1980 at 54-55.

[12] Presiding Officer's Report at 240.

[13] One version of the provision would have allowed exceptions where attorneys' fees are payable to the prevailing party or require a judicial determination that they are reasonable based on the value of services

provision would not have restricted the power of the courts to impose such fees on defaulters under state law, however. Consequently, the provision might have had little effect in some states.[14]

1. Prevalence

A large majority of the states permit attorneys' fees clauses, although some ban them on small loans and/or place limits on the size of the fees.[15] Record evidence indicates that such clauses are included in the great majority of contracts when they are permitted by state law.[16] Attorneys' fees represent a significant share of the average judgment.[17]

2. Benefits

The rationales offered for this provision were that attorneys' fees exceed actual costs, that consumer liability for attorneys' fees discourages the assertion of valid defenses, and that consumer liability reduces creditors' incentives to minimize their legal costs.

The evidence shows that the attorneys' fees assessed against defaulters generally reflect what attorneys charge

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performed. The Commission rejected this version because it was not supported by the record. A provision that attorneys' fees are to be paid by the losing party would have little impact, because debtors have default judgments entered against them in the vast majority of cases. Nothing would be gained from a requirement of judicial determination of reasonableness, because the evidence discussed below suggests that attorneys' fees assessed against defaulters are already subject to state requirements of judicial review for reasonableness.

[14] Presiding Officer's Report at 322.

[15] NCFA, R-XIII-31 at C-22-23, and Presiding Officer's Report at 180.

[16] NCFA, HX-493; NCCF, Technical Studies, Vol. V at 43-45.

[17] The NCLC survey indicates legal aid attorneys believe the average is 20 percent. HX-467, HX-469. The record contains references to figures of 5 to 33 percent in individual cases; *e.g.*, Baker, HX-443 at 1-2; Baker, HX-444 at 5-11; Paer, Tr. 5343; Presiding Officer's Report at 186.

creditors for their services.[18] The evidence also shows that, in some specific instances, what attorneys charge creditors for their services bears little relation to the amount of work performed and may appear excessive. However, this is explained by the way attorneys are paid, *e.g.*, a percentage of the unpaid obligation,[19] and does not imply that [7785] debtors overcompensate creditors. As the Presiding Officer found, on average, "attorneys' fees, as limited by state laws, do not fully reimburse creditors for the amounts they actually expend for such fees."[20]

This provision would benefit borrowers to the extent that, in the event of default, it would increase their bargaining power with creditors and reduce the size of the judgments against them.

Because this provision would reduce the expected cost of defending a lawsuit, under some circumstances it would provide benefits by encouraging the successful assertion of valid defenses. The record contains evidence of instances in which a debtor agreed not to assert a defense in return for the creditor's agreement to waive attorney's fees.[21] The decision to reach a settlement reflects a mutual interest in minimizing legal costs. Although an attorney's fees clause could affect the terms of settlement, it would not necessarily affect the probability of a settlement. In any event, the Commission shares the Presiding Officer's conclusion that the "use of attorneys' fees clauses to persuade consumers to pay debts they do not owe or to forego valid defenses is simply not supported by the evidence in this record."[22]

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[18] *E.g.*, Hellerstein, Tr. 7091-92; Wehner, Tr. 9091; Kushel, HX-388 at 13-16; Goldberg, Tr. 8119, 8136-37; Lavenstein, Tr. 8353; Nestlerode, Tr. 7207.

[19] Presiding Officer's Report at 186.

[20] Presiding Officer's Report at 171.

[21] *E.g.*, Bodron, Tr. 324-26.

[22] Presiding Officer's Report at 182.

The suggestion that this provision would provide benefits by encouraging creditors to limit their legal costs is not sufficiently supported by the record. As with deficiencies, creditors have an incentive to minimize attorneys' fees and other collection costs, because generally they are not fully reimbursed by defaulters.[23]

3. Costs

As is the case with any measure that reduces the costs of default to the borrower, the attorneys' fees provision might increase creditors' collection and other costs. In the event of default and a judgment, what borrowers would gain in reduced judgments as a result of this provision, creditors would lose in reduced recoveries. In addition, if the provision did encourage the assertion of defenses, total legal costs would rise.

4. Commission Decision

After weighing the record evidence, the Commission determined that the costs of this provision outweigh the benefits. This is consistent with the conclusion of the Presiding Officer that " * * * the record does not permit an objective determination that the degree of consumer injury is sufficient to justify prohibiting the inclusion of attorneys' fees clauses in consumer credit contracts."[24]

C. Third Party Contacts

The Commission considered but rejected a provision to prohibit creditor contacts with third parties except to locate the debtor, to determine the nature and extent of the debtor's income or property, or as a court permits.

1. Prevalence

Record evidence indicates that many consumer credit contracts contain provisions expressly waiving the debtor's right

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[23] *E.g.*, Gwennap, Tr. 12217-18; Wohner, Tr. 9091.

[24] Presiding Officer's Report at 186.

to privacy or otherwise permitting third party contacts. At the time credit is extended creditors often obtain names of employers, relatives, friends, and neighbors.[25] Fifteen states limit third party contacts, and two prohibit them.[26]

The NCFA survey of finance company contracts indicates that third party contacts with employers in the case of delinquency occur in 1.5 percent of personal loans and 0.23 percent of sale finance contracts.[27] The percentage increases to 5 percent for loans delinquent 60 days or longer. Some of these contacts are incident to wage assignments and garnishments.[28]

The NCFA survey shows that contacts with third parties other than employers are more frequent, occuring in 12 percent of personal loans and 6 percent of sales finance contracts, and increasing to 35 percent of personal loans which have been delinquent for 60 days or longer.[29] Almost half these contacts are with relatives of the debtor. The vast majority are to locate or leave a message for the debtor. Nonetheless, the survey reveals that about 5 percent of these contacts are to seek collection from a third party.[30]

The record does not contain evidence of widespread abusive third party contacts. In the case of creditor contacts with a debtor's employer, it is in the creditor's interest refrain from abusive conduct because to do otherwise might jeopardize the debtor's earnings.[31]

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[25] *E.g.*, NCLC, HX-467; Avco, R-XI-AVCO-616; General Finance Co., R-XI-GFC-2 at 218-2.

[26] NCFA, R-XIII-31 at C-26-27.

[27] Shay, HX-494 at 57; NCFA, HX-495 at Q11, HX-496 at Q11, HX-497 at Q11, HX-498 at Q11, HX-499 at Q11. NCFA data may understate third party contacts. Demasco, Tr. 11961-11964.

[28] Shay, HX-494 at 63.

[29] NCFA, HX-498 at Q11 and HX-499 at Q11.

[30] *Id.*

[31] Curtis, Tr. 2652; Thomasch, Tr. 8930.

2. Benefits

This provision would benefit borrowers to the extent that it would reduce the ability of creditors to apply pressure to them in the event of default, reduce contacts with employers that might endanger debtors' jobs, reduce loss of privacy, or otherwise reduce abusive contracts. Examples of such abuses shown on the record include threats to reveal information to third parties, disclosures of information to third parties that amount to gross invasions of privacy, threats against third parties, or threats against debtors conveyed to third parties.

The provision requiring a contract clause ruling out third party contacts would produce few benefits because of enforcement problems. In the event of a prohibited third party contact, the debtor would have to sue for breach of contract, and the remedy would be limited to actual damages. It is unlikely that much litigation of this type would occur, because the large majority of judgments against debtors are taken by default.[32]

3. Costs

In some cases, the restriction on third party contacts could work to the detriment of debtors because these contacts may currently prevent the use of more onerous collection methods.[33]

This provision would increase creditors' collection costs and perhaps losses due to default. Many contacts are efficient, legitimate business procedures, *e.g.*, contacts with third parties who might possess the collateral or contacts with

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[32] Caplovitz, *Consumers in Trouble: A Study of Defaulting Debtors*, at 100, and Warner, reporting results of 8 U. Conn. L. Rev. 412 study, Tr. 8303-04. Because of this problem, we also considered a direct prohibition on third party contacts. Even with this change, the provision was rejected because of its other costs, particularly interference with legitimate contacts.

[33] *E.g.*, Schmidt, Tr. 6199-6200; Tanner, HX-171 at 15; Thomas, Tr. 9193-95.

other creditors for purposes of instituting bankruptcy proceedings.[34] A general prohibition on third party contacts of the type contemplated by this provision as proposed would inevitably prevent some useful contacts because of problems in drawing a clear line between abusive and legitimate contacts.

4. Commission Decision

The majority of the Commission decided that the costs of this provision outweigh its benefits. We consider that a case-by-case approach is more appropriate to stem abusive third party **[7786]** contacts without restricting legitimate contacts. In this decision, we departed from the findings of the Presiding Officer, who concluded that any potential benefit from third party contacts was "completely outweighed" by the potential for consumer injury.[35] However, the Presiding Officer did find "a clear necessity for redrafting this provision of the rule so as to permit the creditor use of third party contacts that have a genuine business purpose."[36] We concluded that because of the difficulties of distinguishing contacts that are injurious from those that are beneficial, case-by-case enforcement against contacts that cause injury to consumers is a more cost-effective approach.

D. Late Charges

Another proposed rule provision that we rejected would have prohibited late charges, that is, fees assessed for late payments above and beyond interest on the late payments.

1. Prevalence

Consumer credit contracts almost universally provide for the assessment of late charges, and such charges are usually

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[34] *E.g.*, Childers, Tr. 1186-87.

[35] Presiding Officer's Report at 259.

[36] Presiding Officer's Report at 263.

levied when payments are late.[37] The amounts of these charges are limited by federal and state laws.[38]

2. Benefits

Borrowers would be better off in the event of delinquency if late charges could not be assessed. However, in the absence of pyramiding there is no evidence of creditor abuse in imposing late charges.[39] In general the charges assessed do not fully compensate creditors for the extra costs of handling delinquent accounts.[40]

3. Costs

Late charges serve a dual purpose. They provide an incentive to the debtor to make payments on time, and they partially compensate the creditor for the additional costs[41] involved in collecting delinquent payments. Creditors receive a significant amount of income from late charges.[42]

Without late charges a debtor could effectively convert a precomputed installment contract or loan into open-ended credit. This could create serious portfolio problems for a creditor, and in particular would increase the risks related to changes in interest rates and matching of the terms of assets and liabilities. To prevent this problem, a creditor would have to declare a default and accelerate the due date of the entire balance. Such a choice would injure consumers rather than help them.

4. Commission Decision

The Commission concluded that the costs of the proposed provision outweigh the benefits. The benefits to borrowers would not be sufficient to offset the adverse effects on the cost

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[37] Presiding Officer's Report at 203.

[38] FHA, HX-424 at 3, 24; NCLC, R-I(c)-103 at 64.

[39] Presiding Officer's Report at 195, 203.

[40] *E.g.*, Shay, HX-494 at 55-56.

[41] *E.g.*, Himoto, Tr. 5388; Lapan, Tr. 11479.

[42] Presiding Officer's Report at 203.

and availability of credit. This is consistent with the findings of the Presiding Officer: "there does not appear to be any economic justification for [this provision of] the rule, at least from the standpoint of the consumer."[43]

E. Cross-Collateralization.

Cross-collateralization occur when goods purchased from a retailer on credit are used to secure credit extended for subsequent purchases until the account is cleared. A provision of the proposed rule which we decided not to promulgate would have restricted cross-collateral clauses in installment sales contracts. Essentially, the provision would have required first-in, first-out accounting for credit contracts covering multiple purchases.

1. Prevalence

Cross-collateral clauses are allowed in all but two states; however, another 18 states mandate a first-in, first-out accounting principle similar to the one specified by the proposed provision. Another 16 states mandate an accounting principle, based on proration of payments, which would have been prohibited by the proposed provision.[44]

The NCLC survey of legal aid attorneys and other evidence suggest that cross-collateral clauses are often used by retailers, particularly by sellers of furniture and appliances, in states where they are permitted.[45] However, this evidence is not systematic, and there is insufficient evidence in the record to permit an estimate of the frequency with which such clauses appear.

Also, a majority of the Commission found that there is insufficient evidence that cross-collateral clauses cause any

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[43] Presiding Officer's Report at 325.

[44] NCFA, RX-XIII-31 at C 15-16.

[45] *E.g.*, NCLC, HX-467 at 25-26; Mosley, Tr. 911; O'Connor, Tr. 1660TT; Spanogle, Tr. 9716-7; Levinson, Tr. 8349; Steiner, Tr. 1765; R-GF at SF 114-1 (General Finance Company Manual); R-GECC-437; R-AVCO-767.

notable degree of consumer injury. There is some evidence that use of such provisions by major retailers has not posed problems for consumers.[46]

2. Benefits

Borrowers would probably be better off in the event of default if cross-collateral clauses were restricted, because the amount of collateral subject to repossession would be reduced. However, little is known about the accounting schemes that would be used by creditors if cross-collateral clauses were prohibited or about their implications for consumer debtors.

3. Costs

This provision could significantly reduce the value of purchase money security interests. No payments would be allocated to reducing the principal owed on the most recent purchase until all earlier purchases are paid off. If preceding purchases were not paid off until a year after the most recent one, for example, the only security for the entire amount of the credit extended for the most recent purchase would then be a year-old appliance or piece of furniture.[47]

4. Commission Decision

In light of the fact that the record does not permit a finding regarding the prevalence of cross-collateral clauses or the prevalence of consumer injury, and because the record does suggest important costs that would result from restriction of security for retail credit sales, a majority of the Commission concludes that the benefits of this provision would not outweigh its costs.[48]

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[46] *E.g.*, Tarpley, Tr. 3763-65; Halliburton, R-I(c)-29 at 6-7.

[47] Korten, R-I(a)-240.

[48] In this decision, the Commission departed from the conclusions of the Presiding Officer. Presiding Officer's Report at 316-317.

F. Other Cosigner Provisions

One provision of the originally proposed rule that a majority of the Commission decided not to accept would have required a three-day waiting period before cosigners could obligate themselves;[49] another would have limited cosigner liability; another would have required that the creditor provide the cosigner with copies of all documents signed by the cosigner and all documents furnished to the debtors; another would have required the creditor to notify the cosigner whenever the debtor became delinquent;[50] and [7787] another would have required that the creditor reduce a claim to judgment before seeking payment from the cosigner.

1. Waiting Period

The rationale for the waiting period was primarily the possibility that creditors might use high pressure tactics to secure cosigners, especially in situations where the loan is already in default. The record contains some evidence that such tactics are used,[51] but there is insufficient indication that their incidence is significant.[52] None of the states appear to require such a waiting period.[53]

The provisions would impose two costs every time a cosigner is used: the credit could be delayed, which could be a serious problem in emergency situations, and a second meeting between the creditor and cosigner would be required. Creditors uniformly and vociferously objected that the

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[49] In the latest version, this was restricted to cases where the debtor was already in default. *See* Staff Report at Appendix A, p. 5.

[50] In the latest version, this was restricted to delinquencies of 30 or more days. *Id.* at 5-6.

[51] CIT Financial Services, R-XI-CIT-E, Section L, 418 at 1-22; Piering, Tr. 6877; McCabe, Tr. 8739-8740; Gull, Tr. 3976; Elder, Tr. 3271; Williams, Tr. 4612.

[52] Presiding Officer's Report at 278.

[53] Presiding Officer's Report at 267.

three-day waiting period was unreasonable and unnecessary.[54]

The Presiding Officer found that "in view of the evidence of delay, inconvenience, and costs accompanying a required three-day cooling-off period for cosigners, it is concluded that the record does not support a requirement for so drastic a remedy."[55] We concur in this determination.

2. Cosigner Liability

It was proposed that the cosigner's liability be limited to the total amount of payments for which the debtor is obligated at the time the cosigner signs.[56] This provision would impose a cost on creditors, who would be unable to seek compensation from cosigners for late charges, attorneys fees, and court costs.

The Commission shares the Presiding Officer's conclusion that "there is insufficient justification for the rule's limitation on cosigner liability."[57]

3. Documents

In most states, creditors are not required to give cosigners copies of the documents they sign or other documents, and in most cases these documents are not given.[58] Such documents would assist cosigners in presenting defenses when a creditor

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[54] Viches, Tr. 8588; Baggett, Tr. 863, Cohen, Tr. 2485; Montgomery, Tr. 2574-75; Welsh, Tr. 4127; Schmidt, Tr. 6200; Gwennp, HX-500 at 21; Wehner, HX-380 at 10; Pfeilksticker, Tr. 2347.

[55] Presiding Officer's Report at 286.

[56] Because this could virtually prevent cosigners on open-end accounts, in the latest version the provision would not have applied to such accounts. However, the Commission rejected this restricted version of the provision, because we concluded that the costs of limiting cosigner liability would outweigh the benefits even for closed-end credit.

[57] Presiding Officer's Report at 286.

[58] Butler, HX-488 at 13; Hix, Tr. 1934; Rothschild, Tr. 6804; Consumer Complaint Letters, R-XI-186, R-II(b)-414, R-II(1)-317; Erwin, Tr. 10028; Reisman, Tr. 7145; Williams, R-XVI-15; Corsetti, Tr. 10503.

demands payment from them. The record contains a few references to instances in which cosigners tried unsuccessfully to obtain copies of documents they signed,[59] but no systematic evidence addresses the incidence of this problem. This requirement would increase creditors' costs because many documents, including such things as warranties, are involved.

The Presiding Officer believed that cosigners should be furnished with such documents.[60] The Commission concluded that the record provides insufficient evidence to conclude that unavailability of documents when needed is sufficiently common to offset the costs of providing documents in all instances.

4. Notice of Delinquency

The rationale for requiring notice to the cosigner of delinquency by the debtor is that lack of notice deprives the cosigner of an opportunity to bring pressure to bear on the debtor or otherwise work to forestall more serious delinquency. Cosigners routinely sign waivers of their rights to notice of nonpayment.[61] However, there is little evidence in the record indicating that cosigners are not presently notified of delinquency. On the contrary, there is evidence that they are notified about serious delinquencies, because creditors often seek payment from cosigners.[62] The provision would have required creditors to contact cosigners even in cases of minor delinquency. When minor delinquencies are corrected, an additional notice would be necessary to inform the cosigner of this fact. These repeated contacts would increase creditors' costs. In addition, the required contacts might lead to unnecessary embarrassment for debtors and cosigners alike.

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[59] R-XI-DIAL-174; R-XI-CIT-35; R-XI-CIT-A-52.

[60] Presiding Officer's Report at 286.

[61] Shay, HX-494 at 61-63; Van Norman, R-II(1)-330 at 4.

[62] R-XI-GFC-465; R-XI-CTA-159; R-XI-ASSOC-92; R-XI-CIT-A-902; R-XI-LIB-85.

The Presiding Officer concluded that this provision was unnecessary,[63] and we concur.

5. Remedies Applied First to Debtor

The Commission's conclusion that the majority of defaults occur because the debtor cannot pay[64] suggests that pursuing the cosigner when the debtor can pay is unlikely to constitute a significant problem. Despite isolated indications, no reliable evidence contradicts this proposition.

The proposed provision would increase creditors' collection costs in cases where the debtor cannot pay, because it would require an unnecessary court action. One reason that cosigners are used is that they usually pay without court action when the creditor asks them to do so.[65]

6. Commission Decision

The Commission decided that these proposed provisions would impose substantial costs and that the evidence does not indicate that they would provide benefits in a significant share of cases.

G. Empirical Evidence on the Benefits and Costs of the Disclosure Alternative

An alternative to the rule that we promulgate here was considered but rejected during our final consideration of this proceeding. It would have required disclosure of information to borrowers concerning the contractual remedies available to creditors. The creditor would have been required to give the borrower a one-page, plain English disclosure containing a brief description of various remedies and checkoff boxes to indicate those that were included in the contract.

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[63] Presiding Officer's Report at 286.

[64] *See supra* Chapter III.

[65] Presiding Officer's Report at 284.

The disclosure alternative was proposed to the Commission late in the proceedings; consequently, little empirical evidence in the record directly addresses the benefits and costs of such an alternative.[66]

The case for a disclosure rule would be persuasive if one could establish: (1) There is inefficiently high use of creditor remedies due to a market failure caused by consumer ignorance about the **[7788]** remedies included in loan contracts and their meanings; (2) the disclosure would substantially reduce this ignorance; (3) the cost of the disclosure would not be high; and (4) there are no other important sources of market failure in the market for creditor remedies.

The discussion of benefits and costs presented below focuses on whether these conditions exist. The Commission found that there are in fact other important sources of market failure in the market for creditor remedies, and that consequently the disclosure alternative would not adequately deal with the problems raised by use of certain creditor remedies.

1. Benefits

Although it does not explicitly address a disclosure alternative, the rulemaking record does contain evidence of the extent to which consumers "understand the meaning, legal effect and possible consequences of the provisions included in contracts used in consumer credit transactions."[67] After reviewing the evidence, the Presiding Officer found that "consumers do not have a complete understanding of consumer

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[66] Although disclosure was not a central focus, a few commentators did suggest disclosure remedies. *See* Bankruptcy Judge T. Sam Plowden, HX-408; James Barr, National Association of Federal Credit Unions, R-I(a)-464 at 4; Dan Griffin, R-I(a)-597 at 2-3; John Robbert, Louisiana Consumers League, HX-073, Tr. 1968; Taylor, Faherty, McCutheon, 215-42-1-18-1; Brown, HX-153 at 1-3. Others opposed disclosure remedies. *See* Sidney Margolius, Tr. 11214; Sten, Tr. 5831.

[67] 42 FR 32259 (1977).

credit contracts."[68] He noted that: "Consumer credit contracts are not drafted with a view to making the provisions understandable to the consumer generally and do not contain an adequate explanation of either the consumer's rights or the creditor's obligations."[69] In discussing the individual provisions of the proposed rule, the Presiding Officer's Report often infers evidence of consumer ignorance about contractual creditor remedies as a problem relating to the use of these remedies.

The fact that a significant share of borrowers have incomplete information about available creditor remedies suggests that there is a potential market failure that might be remedied by a disclosure rule. Although there is no direct information on the extent to which a disclosure would reduce consumer ignorance of specific creditor remedies, such a disclosure may well increase general consumer awareness.

If no other market failures restricted consumer choice, improved awareness would increase the ability of consumers to make credit decisions in their best interest and to comparison shop on the basis of creditor remedies. If an increased number of consumers made decisions and comparison shopped on the basis of remedies, creditors would have more incentive to compete with each other by offering those remedies that best satisfy consumer preferences.

Although it does not bear directly on disclosure of remedies, reliable record evidence on the effects of interest rate disclosures under the Truth in Lending (TIL) Act conducted for the National Commission on Consumer Finance (NCCF) indicates the potential effectiveness of disclosure of credit terms. Based on surveys of consumers conducted approximately 15 months after the effective date of the Act, the studies examined consumer awareness of annual percentage rates as well as the extent to which consumers actually shopped for interest rates.

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[68] Presiding Officer's Report at 77.

[69] *Id.*

Prior to the TIL Act, a relatively small percentage of borrowers had an accurate perception of prevailing interest rates for installment credit. The Act significantly increased awareness of prevailing interest rates.[70]

However, awareness of disclosed information is not sufficient to establish that disclosures are useful. An additional issue is the extent to which consumers actually use the disclosed information to shop for credit. Day and Brandt conducted a survey addressing consumer shopping behavior after TIL became effective. They found that over one-fifth of consumers claimed to have compared rates or postponed purchases based on TIL information.[71]

This raises the question whether the level of awareness and the extent of shopping revealed by these studies are sufficient to assure competitive markets. The NCCF concluded:

> In terms of fostering viable rate competition among credit grantors, these levels of awareness produced by TIL are probably adequate. Not all consumers need be aware of the APR or shop for credit to bring about effective price competition. A significant marginal group of consumers who are aware and do shop is sufficient to "police" the market. As Senator Douglas pointed out in the House hearings on HR 11601, "* * * it is the undecided minority that influences the sellers. So you need only have, in my judgment, about 10 percent cost conscious and they will get the firms competing for that 10 percent."[72]

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[70] Shay and Schober, *Consumer Awareness of Annual Percentage Rates of Charge in Consumer Installment Credit: Before and After Truth in Lending Became Effective*, National Commission on Consumer Finance (NCCF), Technical Studies, Vol. I.

[71] Day and Brandt, *A Study of Consumer Credit Decisions: Implications for Present and Prospective Legislation*, NCCF, Technical Studies, Vol. I, Chapter 5.

[72] *Consumer Credit in the United States*, Report of the NCCF at 176 (1972).

The NCCF found: "In summary then, it appears that 15 months after TIL's effective date a large enough body of consumers in the general market had enough *information* to enforce price competition in that market."[73]

However, this conclusion is subject to two important qualifications which limit its relevance to the current rulemaking. First, the NCCF's discussion is concerned with the adequacy of information about interest rate options that are now available to consumers. It does not follow that in other credit areas efficient options will be made available, since there may be other market failures which prevent suppliers from offering them. Indeed, the Commission has concluded that this is the case for restrictions on certain creditor remedies.[74] Second, the NCCF results relate to shopping for interest rates. Consumers are less likely to consider creditor remedies than interest rates when they shop.[75]

We also considered a 1977 survey of consumer awareness of APRs conducted by the Federal Reserve Board.[76] The 1977 Federal Reserve Board survey addressed changes in consumer awareness of APRs since the Truth in Lending Act, thus updating the earlier NCCF studies. The survey also addressed consumer shopping behavior when considering credit transactions.

The survey found substantial increases in awareness of APRs between 1970 and 1977, and suggested that disclosures had provided enough information to influence the competitiveness of the credit market for all consumers, including lower income and less educated individuals. The survey, although it showed significant awareness of APRs by consumers, does not establish that levels of knowledge and shopping

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[73] *Id.* at 177, emphasis in original.

[74] *See supra* Chapter III, which discusses impediments to competition in the market for creditor remedies.

[75] *Id.*, which discusses limitations on consumer shopping for creditor remedies.

[76] 1977 Consumer Credit Survey, Federal Reserve Board, at 6.

as a result of disclosure will necessarily be great enough to assure that disclosure of creditor remedies will work.[77] Again, we are most cognizant of the fact that the elements which influence consumer consideration of contract terms such as interest rates and those which influence consideration of creditor remedies are so fundamentally different as to make [7789] generalizations about the efficacy of disclosures somewhat speculative.

Thus, even though the disclosure alternative might have produced some benefits, we concluded that disclosure would provide a less adequate remedy for existing market failures than would the prohibitory rule promulgated by the Commission. Inefficiently high use of certain creditor remedies results not only from lack of consumer awareness, but from other problems as well. Moreover, lack of consumer awareness of other relevant issues would not be addressed by the disclosure of creditor remedies. For example, some consumers may underestimate the risk of default, and some consumers may not understand legal procedure well enough to grasp the implications of some remedies (*e.g.*, confessions of judgment) even if they are told that such provisions are in the contract.[78]

2. Costs

The principal cost of a disclosure rule would be the resources needed to provide the forms, individualize them for various consumer contracts, and explain them to borrowers,

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[77] Evidence of the effectiveness of disclosure in other contexts (*e.g.*, corrective advertising) is inconclusive and of only marginal relevance to our consideration of creditor remedy disclosures. *See, e.g.*, sources cited in memorandum to the Commission from Carol Crawford, Director, Bureau of Consumer Protection, and Wendy L. Gramm, Director, Bureau of Economics, July 1, 1983, at 9-12, nn. 27-33.

[78] For example, in a discussion of disclosure with respect to confessions of judgment, the Presiding Officer reported an argument that disclosure would be inadequate: "[E]ven if there is a bold-face disclosure, it was said that the idea of a suit without notice or a hearing is so foreign to the American consumer that he fails to comprehend it." *Presiding Officer's Report* at 90, *citing* Carolyn C. McTighe, Legal Aid Society of Cleveland, R-I(c)-38.

together with the resources needed to enforce the rule. Unlike the accepted rule, which restricts the use of collateral and collection procedures, the disclosure alternative would not prohibit the use of contract terms between informed borrowers and creditors. As a result, a disclosure alternative would avoid most of the costs of the accepted rule and any resulting effects on the cost and availability of credit.

3. Commission Decision

The Commission concluded that the benefits of the promulgated rule would exceed those of the disclosure alternative. Although the Commission also found that the costs of the promulgated rule would exceed those of the disclosure alternative, it concluded that the net benefits of the promulgated rule would exceed the net benefits that would result from a rule based on disclosures. In particular, a disclosure alternative would not address other impediments to shopping that prevent creditors from competing to supply the creditor remedies which informed borrowers would most prefer.

Accordingly, Title 16 of the Code of Federal Regulations is amended by the addition of new Part 444.

APPENDIX D

FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

December 17, 1980

The Honorable Wendell H. Ford
Chairman, Consumer Subcommittee
Committee on Commerce, Science, and Transportation
Room 130 Russell Office Building
Washington, D.C. 20510

The Honorable John C. Danforth
Ranking Minority Member, Consumer Subcommittee
Committee on Commerce, Science, and Transportation
Room 130 Russell Office Building
Washington, D.C. 20510

Dear Senators Ford and Danforth:

This is in response to your letter of June 13, 1980, concerning one aspect of this agency's jurisdiction over "unfair or deceptive acts or practices." You informed us that the Subcommittee was planning to hold oversight hearings on the concept of "unfairness" as it has been applied to consumer transactions. You further informed us that the views of other interested parties were solicited and compiled in a Committee Print earlier this year.[1] Your letter specifically requested the Commission's views on cases under Section 5 "not involving the content of advertising," and its views as to "whether the Commission's authority should be limited to regulating 'false or deceptive' commercial advertising." Our response addresses these and other questions related to the concept of consumer unfairness.

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[1] Unfairness Views on Unfair Acts and Practices in Violation of the Federal Trade Commission Act (1980) (hereinafter referred to as "Committee Print").

We are pleased to have this opportunity to discuss the future work of the agency. The subject that you have selected appears to be particularly timely. We recognize that the concept of consumer unfairness is one whose precise meaning is not immediately obvious, and also recognize that this uncertainty has been honestly troublesome for some businesses and some members of the legal profession. This result is understandable in [2] light of the general nature of the statutory standard. At the same time, though, we believe we can respond to legitimate concerns of business and the Bar by attempting to delineate in this letter a concrete framework for future application of the Commission's unfairness authority. We are aided in this process by the cumulative decisions of this agency and the federal courts, which, in our opinion, have brought added clarity to the law. Although the administrative and judicial evolution of the consumer unfairness concept has still left some necessary flexibility in the statute, it is possible to provide a reasonable working sense of the conduct that is covered.

In response to your inquiry we have therefore undertaken a review of the decided cases and rules and have synthesized from them the most important principles of general applicability. Rather than merely reciting the law, we have attempted to provide the Committee with a concrete indication of the manner in which the Commission has enforced, and will continue to enforce, its unfairness mandate. In so doing we intend to address the concerns that have been raised about the meaning of consumer unfairness, and thereby attempt to provide a greater sense of certainty about what the Commission would regard as an unfair act or practice under Section 5.

This letter thus delineates the Commission's views of the boundaries of its consumer unfairness jurisdiction and is subscribed to by each Commissioner. In addition, we are enclosing a companion Commission statement that discusses the ways in which this body of law differs from, and supplements,

the prohibition against consumer deception, and then considers and evaluates some specific criticisms that have been made of our enforcement of the law.[2] Since you have indicated a particular interest in the possible application of First Amendment principles to commercial advertising, the [3] companion statement will include discussions relevant to that question. The companion statement is designed to respond to the key questions raised about the unfairness doctrine. However, individual Commissioners may not necessarily endorse particular arguments or particular examples of the Commission's exercise of its unfairness authority contained in the companion statement.

Commission Statement of Policy on the Scope of the Consumer Unfairness Jurisdiction

Section 5 of the FTC Act prohibits, in part, "unfair . . . acts or practices in or affecting commerce."[3] This is commonly referred to as the Commission's consumer unfairness jurisdiction. The Commission's jurisdiction over "unfair methods of competition" is not discussed in this letter.[4] Although we cannot give an exhaustive treatment of the law of consumer unfairness in this short statement, some relatively concrete conclusions can nonetheless be drawn.

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[2] Neither this letter nor the companion statement addresses ongoing proceedings, but the Commission is prepared to discuss those matters separately at an appropriate time.

[3] The operative sentence of Section 5 reads in full as follows: "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful." 15 U.S.C. § 45(a)(1).

[4] In fulfilling its competition or antitrust mission the Commission looks to the purposes, policies, and spirit of the other antitrust laws and the FTC Act to determine whether a practice affecting competition or competitors is unfair. *See, e.g., FTC* v. *Brown Shoe Co.*, 384 U.S. 316 (1966). In making this determination the Commission is guided by the extensive legislative histories of those statutes and a considerable body of antitrust case law. The agency's jurisdiction over "deceptive acts or practices" is likewise not discussed in this letter.

The present understanding of the unfairness standard is the result of an evolutionary process. The statute was deliberately framed in general terms since Congress recognized the impossibility of drafting a complete list of unfair trade [4] practices that would not quickly become outdated or leave loopholes for easy evasion.[5] The task of identifying unfair trade practices was therefore assigned to the Commission, subject to judicial review,[6] in the expectation that the underlying criteria would evolve and develop over time. As the Supreme Court observed as early as 1931, the ban on unfairness "belongs to that class of phrases which do not admit of precise definition, but the meaning and application of which must be arrived at by what this court elsewhere has called " 'the gradual process of judicial inclusion and exclusion.' "[7]

By 1964 enough cases had been decided to enable the Commission to identify three factors that it considered when applying the prohibition against consumer unfairness. These were: (1) whether the practice injures consumers; (2) whether it violates established public policy; (3) whether it is unethical or unscrupulous.[8] These factors [5] were later quoted with

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[5] *See* H.R. Conf. Rep. No. 1142, 63d Cong., 2d Sess., at 19 (1914) (If Congress "were to adopt the method of definition, it would undertake an endless task"). In 1914 the statute was phrased only in terms of "unfair methods of competition," and the reference to "unfair acts or practices" was not added until the Wheeler-Lea Amendment in 1938. The initial language was still understood as reaching most of the conduct now characterized as consumer unfairness, however, and so the original legislative history remains relevant to the construction of that part of the statute.

[6] The Supreme Court has stated on many occasions that the definition of "unfairness" is ultimately one for judicial determination. *See, e.g., FTC* v. *Sperry & Hutchinson Co.*, 405 U.S. 233, 249 (1972); *FTC* v. *R.F. Keppel & Bro.*, 291 U.S. 304, 314 (1934).

[7] *FTC* v. *Raladam Co.*, 283 U.S. 643, 648 (1931). *See also FTC* v. *R.F. Keppel & Bro.*, 291 U.S. 304, 310 (1934) ("Neither the language nor the history of the Act suggests that Congress intended to confine the forbidden methods to fixed and unyielding categories").

[8] The Commission's actual statement of the criteria was as follows:

> (1) whether the practice, without necessarily having been previously considered unlawful, offends public policy as it has been established

apparent approval by the Supreme Court in the 1972 case of *Sperry & Hutchinson*.[9] Since then the Commission has continued to refine the standard of unfairness in its cases and rules, and it has now reached a more detailed sense of both the definition and the limits of these criteria.[10]

Consumer injury

Unjustified consumer injury is the primary focus of the FTC Act, and the most important of the three *S&H* criteria. By itself it can be sufficient to warrant a finding of unfairness. The Commission's ability to rely on an independent criterion of consumer injury is consistent with the intent of the statute, which was to "[make] the consumer who may be injured by an unfair trade practice of equal concern before the law with the merchant injured by the unfair methods of a dishonest competitor."[11]

The independent nature of the consumer injury criterion does not mean that every consumer injury is legally "unfair," however. To justify a finding of unfairness the injury must satisfy three tests. It must be substantial; it must not be outweighed by any countervailing benefits to consumers or competition that the practice produces; and it must be an

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by statutes, the common law, or otherwise—whether, in other words, it is within at least the penumbra of some common-law, statutory, or other established concept of unfairness; (2) whether it is immoral, unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers (or competitors or other businessmen).

Statement of Basis and Purpose, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, 29 Fed. Reg. 8324, 8355 (1964).

[9] *FTC* v. *Sperry & Hutchinson Co.*, 405 U.S. 223, 244-45 n.5 (1972). The Circuit Courts have concluded that this quotation reflected the Supreme Court's own views. *See Spiegel, Inc.* v. *FTC*, 540 F.2d 287, 293 n.8 (7th Cir. 1976); *Heater* v. *FTC*, 503 F.2d 321, 323 (9th Cir. 1974). The application of these factors to antitrust matters is beyond the scope of this letter.

[10] These standards for unfairness are generally applicable to both advertising and non-advertising cases.

[11] 83 Cong. Rec. 3255 (1938) (remarks of Senator Wheeler).

injury that consumers themselves could not reasonably have avoided.

First of all, the injury must be substantial. The Commission is not concerned with trivial or merely speculative harms.[12] In most cases a substantial injury involves monetary harm, as when sellers coerce consumers into purchasing unwanted goods or **[6]** services[13] or when consumers buy defective goods or services on credit but are unable to assert against the creditor claims or defenses arising from the transaction.[14] Unwarranted health and safety risks may also support a finding of unfairness.[15] Emotional impact and other more subjective types of harm, on the other hand, will not ordinarily make a practice unfair. Thus, for example, the Commission will not seek to ban an advertisement merely because it offends the tastes or social beliefs of some viewers, as has been suggested in some of the comments.[16]

Second, the injury must not be outweighed by any offsetting consumer or competitive benefits that the sales practice also produces. Most business practices entail a mixture of

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[12] An injury may be sufficiently substantial, however, if it does a small harm to a large number of people, or if it raises a significant risk of concrete harm.

[13] *See, e.g., Holland Furnace Co.* v. *FTC*, 295 F.2d 302 (7th Cir. 1961) (seller's servicemen dismantled home furnaces and then refused to reassemble them until the consumers had agreed to buy services or replacement parts).

[14] Statement of Basis and Purpose, Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53506, 53522-23 (1975).

[15] For an example see *Philip Morris, Inc.*, 82 F.T.C. 16 (1973) (respondent had distributed free-sample razor blades in such a way that they could come into the hands of small children) (consent agreement). Of course, if matters involving health and safety are within the primary jurisdiction of some other agency, Commission action might not be appropriate.

[16] *See, e.g.*, comments of Association of National Advertisers, Committee Print at 120. In an extreme case, however, where tangible injury could be clearly demonstrated, emotional effects might possibly be considered as the basis for a finding of unfairness. *Cf.* 15 U.S.C. §§ 1692 *et seq.* (Fair Debt Collection Practices Act) (banning, *e.g.*, harrassing late-night telephone calls).

economic and other costs and benefits for purchasers. A seller's failure to present complex technical data on his product may lessen a consumer's ability to choose, for example, but may also reduce the initial price he must pay for the article. The Commission is aware of these tradeoffs and will not find that a practice unfairly injures consumers unless it is injurious in its net effects.[17] The Commission [7] also takes account of the various costs that a remedy would entail. These include not only the costs to the parties directly before the agency, but also the burdens on society in general in the form of increased paperwork, increased regulatory burdens on the flow of information, reduced incentives to innovation and capital formation, and similar matters. [18]

Finally, the injury must be one which consumers could not reasonably have avoided. [19] Normally we expect the marketplace to be self-correcting, and we rely on consumer choice—the ability of individual consumers to make their own private purchasing decisions without regulatory intervention—to govern the market. We anticipate that consumers

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[17] *See Pfizer, Inc.*, 81 F.T.C. 23, 62-63 n.13 (1972); Statement of Basis and Purpose, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59614, 59636 n.95 (1978). When making this determination the Commission may refer to existing public policies for help in ascertaining the existence of consumer injury and the relative weights that should be assigned to various costs and benefits. The role of public policy in unfairness determinations will be discussed more generally below.

[18] For example, when the Commission promulgated the Holder Rule it anticipated an overall lowering of economic costs to society because the rule gave creditors the incentive to police sellers, thus increasing the likelihood that those selling defective goods or services would either improve their practices or leave the marketplace when they could not obtain financing. These benefits, in the Commission's judgment, outweighed any costs to creditors and sellers occasioned by the rule. *See* Statement of Basis and Purpose, Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53506, 53522-23 (1975).

[19] In some senses any injury can be avoided—for example, by hiring independent experts to test all products in advance, or by private legal actions for damages—but these courses may be too expensive to be practicable for individual consumers to pursue.

will survey the available alternatives, choose those that are most desirable, and avoid those that are inadequate or unsatisfactory. However, it has long been recognized that certain types of sales techniques may prevent consumers from effectively making their own decisions, and that corrective action may then become necessary. Most of the Commission's unfairness matters are brought under these circumstances. They are brought, not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decisionmaking. [20][8]

Sellers may adopt a number of practices that unjustifiably hinder such free market decisions. Some may withhold or fail to generate critical price or performance data, for example, leaving buyers with insufficient information for informed comparisons. [21] Some may engage in overt coercion, as by dismantling a home appliance for "inspection" and refusing to reassemble it until a service contract is signed.[22] And some may exercise undue influence over highly susceptible classes

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[20] This emphasis on informed consumer choice has commonly been adopted in other statutes as well. *See, e.g.*, Declaration of Policy, Fair Packaging and Labeling Act, 15 U.S.C. § 1451 ("Informed consumers are essential to the fair and efficient functioning of a free market economy").

[21] *See, e.g.*, Statement of Basis and Purpose, Labeling and Advertising of Home Insulation, 44 Fed. Reg. 50218, 50222-23 (1979); Statement of Basis and Purpose, Posting of Minimum Octane Numbers on Gasoline Dispensing Pumps, 36 Fed. Reg. 23871, 23882 (1971). *See also Virginia State Board of Pharmacy* v. *Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748 (1976).

[22] *See Holland Furnace Co.* v. *FTC*, 295 F.2d 302 (7th Cir. 1961); *cf. Arthur Murray Studio, Inc.* v. *FTC*, 458 F.2d 622 (5th Cir. 1972) (emotional high-pressure sales tactics, using teams of salesmen who refused to let the customer leave the room until a contract was signed). *See also* Statement of Basis and Purpose, Cooling-Off Period for Door-to-Door Sales, 37 Fed. Reg. 22934, 22937-38 (1972).

of purchasers, as by promoting fraudulent "cures" to seriously ill cancer patients.[23] Each of these practices undermines an essential precondition to a free and informed consumer transaction, and, in turn, to a well-functioning market. Each of them is therefore properly banned as an unfair practice under the FTC Act.[24][9]

Violation of public policy

The second *S&H* standard asks whether the conduct violates public policy as it has been established by statute, common law, industry practice, or otherwise. This criterion may be applied in two different ways. It may be used to test the validity and strength of the evidence of consumer injury, or, less often, it may be cited for a dispositive legislative or judicial determination that such injury is present.

Although public policy was listed by the *S&H* Court as a separate consideration, it is used most frequently by the Commission as a means of providing additional evidence on the degree of consumer injury caused by specific practices. To be sure, most Commission actions are brought to redress relatively clear-cut injuries, and those determinations are based, in large part, on objective economic analysis. As we have indicated before, the Commission believes that considerable

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[23] *See, e.g., Travel King, Inc.*, 86 F.T.C. 715, 774 (1975). The practices in this case primarily involved deception, but the Commission noted the special susceptibilities of such patients as one reason for banning the ads entirely rather than relying on the remedy of fuller disclosure. The Commission recognizes that "undue influence" in advertising and promotion is difficult to define, and therefore exercises its authority here only with respect to substantial coercive-like practices and significant consumer injury.

[24] These few examples are not exhaustive, but the general direction they illustrate is clear. As the Commission stated in promulgating its Eyeglasses Rule, the inquiry should begin, at least, by asking "whether the acts or practices at issue inhibit the functioning of the competitive market and whether consumers are harmed thereby." Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, 43 Fed. Reg. 23992, 24001 (1978).

attention should be devoted to the analysis of whether substantial net harm has occurred, not only because that is part of the unfairness test, but also because the focus on injury is the best way to ensure that the Commission acts responsibly and uses its resources wisely. Nonetheless, the Commission wishes to emphasize the importance of examining outside statutory policies and established judicial principles for assistance in helping the agency ascertain whether a particular form of conduct does in fact tend to harm consumers. Thus the agency has referred to First Amendment decisions upholding consumers' rights to receive information, for example, to confirm that restrictions on advertising tend unfairly to hinder the informed exercise of consumer choice.[25] **[10]**

Conversely, statutes or other sources of public policy may affirmatively allow for a practice that the Commission tentatively views as unfair. The existence of such policies will then give the agency reason to reconsider its assessment of whether the practice is actually injurious in its net effects.[26] In other situations there may be no clearly established public policies, or the policies may even be in conflict. While that does not necessarily preclude the Commission from taking action if there is strong evidence of net consumer injury, it does underscore the desirability of carefully examining public policies in all instances.[27] In any event, whenever objective

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[25] *See* Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, 43 Fed. Reg. 23992, 24001 (1978), *citing Virginia State Board of Pharmacy* v. *Virginia Citizens Consumer Council*, 425 U.S. 748 (1976).

[26] *Cf.* Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, *supra; see also* n.17 *supra*.

[27] The analysis of external public policies is extremely valuable but not always definitive. The legislative history of Section 5 recognizes that new forms of unfair business practices may arise which, at the time of the Commission's involvement, have not yet been generally proscribed. *See* page 4, *supra*. Thus a review of public policies established independently of Commission action may not be conclusive in determining whether the challenged practices should be prohibited or otherwise restricted. At the same time, however, we emphasize the importance of examining public

evidence of consumer injury is difficult to obtain, the need to identify and assess all relevant public policies assumes increased importance.

Sometimes public policy will independently support a Commission action. This occurs when the policy is so clear that it will entirely determine the question of consumer injury, so there is little need for separate analysis by the Commission. In these cases the legislature or court, in announcing the policy, has already determined that such injury does exist and thus it need not be expressly proved in each instance. An example [11] of this approach arose in a case involving a mail-order firm.[28] There the Commission was persuaded by an analogy to the due-process clause that it was unfair for the firm to bring collection suits in a forum that was unreasonably difficult for the defendants to reach. In a similar case the Commission applied the statutory policies of the Uniform Commercial Code to require that various automobile manufacturers and their distributors refund to their customers any surplus money that was realized after they repossessed and resold their customer's cars.[29] The Commission acts on such a basis only where the public policy is

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policies, since a thorough analysis can serve as an important check on the overall reasonableness of the Commission's actions.

[28] *Spiegel, Inc.* v. *FTC*, 540 F.2d 287 (7th Cir. 1976). In this case the Commission did inquire into the extent of the resulting consumer injury, but under the rationale involved it presumably need not have done so. *See also FTC* v. *R. Keppel & Bro.*, 291 U.S. 304 (1934) (firm had gained a marketing advantage by selling goods through a lottery technique that violated state gambling policies); *cf. Simeon Management Corp.*, 87 F.T.C. 1184, 1231 (1976), *aff'd*, 579 F.2d 1137 (9th Cir. 1978) (firm advertised weight-loss program that used a drug which could not itself be advertised under FDA regulations) (alternative ground). Since these public-policy cases are based on legislative determinations, rather than on a judgment within the Commission's area of special economic expertise, it is appropriate that they can reach a relatively wider range of consumer injuries than just those associated with impaired consumer choice.

[29] A surplus occurs when a repossessed car is resold for more than the amount owed by the debtor plus the expenses of repossession and resale. The law of 49 states requires that creditors refund surpluses when they

suitable for administrative enforcement by this agency, however. Thus it turned down a petition for a rule to require fuller disclosure of aerosol propellants, reasoning that the subject of fluorocarbon safety was currently under study by other scientific and legislative bodies with more appropriate expertise or jurisdiction over the subject.[30] **[12]**

To the extent that the Commission relies heavily on public policy to support a finding of unfairness, the policy should be clear and well-established. In other words, the policy should be declared or embodied in formal sources such as statutes, judicial decisions, or the Constitution as interpreted by the courts, rather than being ascertained from a general sense of the national values. The policy should likewise be one that is widely shared, and not the isolated decision of a single state or a single court. If these two tests are not met the policy cannot be considered as an "established" public policy for purposes of the *S&H* criterion. The Commission would then act only on the basis of convincing independent evidence that the practice was distorting the operation of the market and thereby causing unjustified consumer injury.

Unethical or unscrupulous conduct

Finally, the third *S&H* standard asks whether the conduct was immoral, unethical, oppressive, or unscrupulous. This

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occur, but if creditors systematically refuse to honor this obligation, consumers have no practical way to discover that they have been deprived of money to which they are entitled. *See Ford Motor Co.*, 94 F.T.C. 564, 618 (1979), *appeal pending*, Nos. 79-7649 and 79-7654 (9th Cir.); *Ford Motor Co.*, 93 F.T.C. 402 (1979) (consent decree); *General Motors Corp.*, D. 9074 (Feb., 1980) (consent decree). By these latter two consent agreements the Commission, because of its unfairness jurisdiction, has been able to secure more than $2 million for consumers allegedly deprived of surpluses to which they were entitled.

[30] *See* Letter from John F. Dugan, Acting Secretary, to Action on Smoking and Health (January 13, 1977). *See also* Letter from Charles A. Tobin, Secretary, to Prof. Page and Mr. Young (September 17, 1973) (denying petition to exercise § 6(b) subpoena powers to obtain consumer complaint information from cosmetic firms and then to transmit the data to FDA for that agency's enforcement purposes).

test was presumably included in order to be sure of reaching all the purposes of the underlying statute, which forbids "unfair" acts or practices. It would therefore allow the Commission to reach conduct that violates generally recognized standards of business ethics. The test has proven, however, to be largely duplicative. Conduct that is truly unethical or unscrupulous will almost always injure consumers or violate public policy as well. The Commission has therefore never relied on the third element of *S&H* as an independent basis for a finding of unfairness, and it will act in the future only on the basis of the first two.[13]

We hope this letter has given you the information that you require. Please do not hesitate to call if we can be of any further assistance. With best regards,

Michael Pertschuk
Chairman

Paul Rand Dixon
Commissioner

David A. Clanton
Commissioner

Robert Pitofsky
Commissioner

Patricia P. Bailey
Commissioner

Enclosure

COMPANION STATEMENT ON THE COMMISSION'S CONSUMER UNFAIRNESS JURISDICTION

This statement is intended to supplement the Commission's letter on the consumer unfairness jurisdiction. It will discuss two additional subjects. The first is the manner in which the unfairness jurisdiction relates to and complements the ban against deceptive practices, and the second is a consideration of certain specific criticisms that have been made of the enforcement of the unfairness jurisdiction.[1]

I. The Need for the Prohibition of Unfair Acts or Practices

The Commission's unfairness jurisdiction has become an important part of its ability to protect consumers against certain abusive practices. The unfairness standard supplements, rather than duplicates, other aspects of the FTC Act. The various components of the statute form an integrated whole, allowing the Commission to promote the diverse benefits of a free and open economy. Thus the ban on unfair competition prevents exclusionary or anticompetitive behavior and helps preserve a full variety of marketplace options for consumers to choose among; the ban on deception helps ensure that consumers will not make that choice on the basis of misleading information; and the ban on unfair practices ensures that the choice is not distorted by coercion, the withholding of important information, or similar practices. Safeguards at all three levels are needed to ensure that substantial consumer injury is adequately addressed.[2]

There are many ways in which consumer decisions may be distorted or coerced without resort to clear, outright deception. For this reason, the Commission has challenged many practices, including most of those discussed below, as both deceptive and unfair. Elimination of the Commission's

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[1] As before, this statement does not address the Commission's jurisdiction over unfair methods of competition.

unfairness jurisdiction and sole reliance on a deception standard in its stead[2] would at best create ambiguity about the status of such practices and at worse permit significant abuses that the law now clearly prevents. The drawbacks of eliminating the Commission's unfairness jurisdiction are illustrated by the Eyeglasses Rule, which involved several different restraints on consumer choice.[3] The Commission found that many optometrists refused to give customers written copies of their lens prescriptions, so that consumers who received eye examinations from one practitioner were prevented from shopping to buy their eyeglasses from less expensive providers. These restraints were not deceptive, but they often prevented consumers from buying eyeglasses at the lowest possible price. Their combined effect was to inflate artificially the cost of eye care, a burden which fell most heavily on the poor and the elderly. A statute which did not prohibit unfair acts or practices would have made it difficult for the Commission to prevent this injury.

Buyers are sometimes overtly coerced. Some sellers have, for example, pressured consumers into a distraught state of mind, even physically preventing them from leaving the room during the sales presentation, in order to coerce a sale.[4] In other instances, [3] door-to-door salesmen have refused to leave customers' homes until they purchased expensive goods

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[2] Some suggestions to this effect have appeared in the Committee Print. *See, e.g.*, Comments of General Mills, Inc. (Committee Print at p. 22); Comments of Sears, Roebuck & Co. (Committee Print at p. 139); Comments of the American Retail Federation (Committee Print at p. 156).

[3] Trade Regulation Rule, Advertising of Ophthalmic Goods and Services, 43 Fed. Reg. 23992 (1978). Portions of the rule were later remanded for the Commission to determine whether sellers had changed their practices in light of recent Supreme Court decisions. *American Optometric Ass'n v. FTC*, 626 F.2d 896 (D.C. Cir. 1980).

[4] *Arthur Murray Studio, Inc.*, 78 F.T.C. 401, 439-41 (1971), *aff'd*, 458 F.2d 622 (5th Cir. 1972).

or services.[5] Both of these practices were so coercive that they tended to curtail the free exercise of consumer choice.

Sometimes consumer unfairness is found even without coercion or denials of product information. A striking example arose in the early 1970's when a company began promoting razor blades in a way that risked serious injury to small children. Free samples of the blades were included indiscriminately in advertising supplements to home-delivered newspapers, without any protective packaging that would keep children who found them from injuring themselves. The Commission was able to use its unfairness jurisdiction to negotiate a consent decree barring this unsafe marketing technique.[6] A statute allowing the Commission to move only against deception might have left it less able to protect children against the practice.

Most of the Commission's consumer unfairness actions have historically been directed against techniques other than commercial advertising, since the most serious abuses in advertising have often involved some form of deception and thus could be challenged directly under that portion of the statute. However, the Commission has also encountered injurious advertising practices which ought to be prohibited, and that could most readily be characterized as unfair. Thus the Commission has used its authority over unfair acts and practices to negotiate consent decrees barring advertisements which needlessly depicted young children engaged in unsafe or illegal behavior, thereby creating **[4]** a danger that other children would be led to imitate what they saw.[7] Also, the

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[5] *See* Statement of Basis and Purpose, Cooling-Off Period for Door-to-Door Sales, 37 Fed. Reg. 22934 (1972). Other aspects of this rule, of course, involved deceptive practices. For a litigated case involving the rule see *New Rapids Carpet Center, Inc.*, 90 F.T.C. 64, 119-20 (1977).

[6] *Philip Morris, Inc.*, 82 F.T.C. 16 (1973).

[7] *E.g., AMF, Inc.*, C-3011 (1980) (bicycle advertisement showing children riding bicycles in violation of proper highway safety rules); *Mego International*, 92 F.T.C. 186 (1978) (children playing with electrical appliances near water and without adult supervision); *Uncle Ben's, Inc.*, 89

Commission has required advertisements to disclose product information that was necessary for consumers to compare the efficiency of competing brands of home insulation[8] and the octane levels of competing brands of gasoline.[9] The absence of this information tended seriously to undercut the ability of consumers to make rational product choices, causing substantial consumer injury.

As we have noted before, certain aspects of these practices might be reached under a deception theory, but the issue is unclear and it seems difficult to rely exclusively on deception to reach all instances of coercion, overreaching and inadequate product information disclosure. It might, of course, be theoretically possible to correct these abuses individually, by passing a series of specifically tailored prohibitions without resort to a general statutory ban on unfair acts and practices. This approach has serious drawbacks, however; indeed, it was considered and rejected by Congress nearly seventy years ago when it first enacted Section 5. As the Senate Commerce Committee reasoned then,

> The Committee gave careful consideration to the question as to whether it would attempt to define the many and variable unfair practices which prevail in commerce and to forbid their continuance or whether it would, by a general declaration condemning unfair practices, leave it to the commission to determine what practices were unfair. It concluded that the latter course would be better, for the reason, as stated by one [5] of the representatives of the Illinois Manufacturers' Association, that there were

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F.T.C. 131 (1977) (advertisement showing young children cooking on a gas range without adult supervision); *General Foods Corp.*, 86 F.T.C. 831 (1975) (natural-food advocate eating wild nuts and berries).

[8] Trade Regulation Rule, Labeling and Advertising of Home Insulation, 44 Fed. Reg. 50218 (1979).

[9] Trade Regulation Rule, Posting of Minimum Octane Numbers on Gasoline Dispensing Pumps, 36 Fed. Reg. 23871 (1971). The Commission found that it would be more effective to disclose the information at the point of sale than in media advertising, but the principle is the same.

> too many unfair practices to define, and after writing 20 of them into law it would be quite possible to invent others.[10]

In short, the language of "unfairness" has been an integral part of the FTC Act from its beginnings. It represents a considered judgment on the part of Congress and the courts that the Commission can interpret a reasonably flexible statute with sufficient specificity to protect consumers in the context of a continually evolving marketplace. The unfairness standard, in conjunction with the rule against deception, is necessary to enable the Commission to address the full range of business practices that result in substantial injury to consumers and distortion of the marketplace.

II. Specific Criticisms of the Consumer Unfairness Authority

Notwithstanding the general development of the FTC's consumer unfairness authority as described above, some specific questions have been raised about its application to particular circumstances. A number of these have been collected in the Committee Print, "Views on Unfair Acts and Practices in Violation of the Federal Trade Commission Act." There appear to be three major questions. These express concern that the unfairness authority: (1) is an overbroad delegation of discretionary authority which allows the Commission to restrict practices that cause no consumer injury; (2) fails to give adequate notice of what conduct will be considered unfair; and (3) may violate the First Amendment when applied to commercial speech. Each of these points will be considered in turn.**[6]**

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[10] *S. Rep. No. 597*, 63d Cong., 2d Sess. 13 (1914). *See also H.R. Rep. No. 1142*, 63d Cong., 2d Sess. 19 (1914) ("It is also practically impossible to define unfair practices so that the definition will fit business of every sort in every part of this country. Whether competition is unfair or not generally depends upon the surrounding circumstances of the particular case.")

Agency discretion and consumer injury

The discussion in our letter on the limits to the Commission's unfairness jurisdiction will, we hope, allay concerns that the agency might find practices to be unfair in the absence of consumer injury, or that its unfairness jurisdiction leaves too much to its discretion. As stated therein, the presence of unjustified consumer injury—whether shown by objective evidence, by clear public policy, or both—is essential to a determination that particular conduct is unfair. Similarly, the discussion should indicate that the bounds of the Commission's discretion under its unfairness jurisdiction have been clarified and limited.

In addition to the definable limits on unfairness as described in the Commission's letter, there are also external procedural checks which ensure that the agency does not overstep the bounds of intended congressional delegation. Industry-wide rules are subject to formal congressional review under the terms of recent amendments to the Federal Trade Commission Act.[11] Further, all Commission rules and orders are subject to judicial review.[12] Professor Kenneth Culp Davis, a leading authority on administrative law, has concluded that safeguards of this type provide a more meaningful check on agency discretion than would actions to prescribe more specific standards.[13][7] Congressional and judicial review of agency determinations of unfairness will, moreover,

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[11] *See* FTC Improvements Act of 1980, Pub. L. 96-252, § 21.

[12] *See, e.g., FTC* v. *Sperry & Hutchinson Co.*, 405 U.S. 233, 249 (1972); *FTC v.* R. F. Keppel & Bro., 291 U.S. 304, 314 (1934).

[13] *See* K. DAVIS, ADMINISTRATIVE LAW TREATISE, § 2.00-3, at 47 (1970 Supp.). For this reason statutes that imply a similar degree of discretion in other agencies have been regularly upheld. *See, e.g., National Broadcasting Co.* v. *United States*, 319 U.S. 190 (1943) (upholding FCC's reliance on its power to license broadcasting stations in "the public interest, convenience, or necessity" as authority for issuing regulations concerning contractual relations between broadcasters and networks); *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) (upholding the Federal Power Commission's area rate fixing regulations under the statutory power to determine whether independent producers of natural gas have rates that are

contribute to the continual process of more precisely defining the proper scope of the Commission's unfairness jurisdiction.

Adequacy of notice

A second concern is that the statutory term "unfair" is too imprecise to give businesses adequate notice of what conduct will be considered improper. To the extent that this concern rests on questions about the scope of agency discretion, these issues have been addressed above. To the extent that this concern also rests upon perceptions of procedural unfairness, the Commission would like to bring to the committee's attention procedural protections that currently exist in both its adjudicative and rulemaking proceedings.

Under the Federal Trade Commission Act, businesses cannot be subjected to sanctions for engaging in an unfair practice until the practice has been defined with specificity in a full-dress adjudication or rulemaking.[14] If, in an adjudication, a firm is found to have engaged in a newly identified unfair act or practice, civil penalties are not assessed; rather, the remedies are limited to preventing the firm from engaging in the same or related practices in the future,[15] and, in appropriate cases, to providing relief for injured parties. Only if the order is violated may penalties then be assessed.[16] **[8]** There are also some special provisions for immediate consumer redress, but these apply only to conduct that "a reasonable man would have known under the circumstances was dishonest or fraudulent," and that determination must be made in federal court.[17]

"just and reasonable"). While these other agencies may have a more specific subject matter under their jurisdiction, within that jurisdiction they have a degree of discretion that is not unlike the FTC's.

[14] *See* 15 U.S.C. §§ 45(b), 57a.

[15] 15 U.S.C. § 45(b). *See FTC* v. *Colgate-Palmolive Co.*, 380 U.S. 374, 394-95 (1965); *FTC* v. *National Lead*, 352 U.S. 419, 429 (1957); *FTC* v. *Ruberoid Co.*, 343 U.S. 470, 473 (1952); *Joseph Siegel Co.* v. *FTC*, 327 U.S. 608, 612-13 (1946).

[16] *See* 15 U.S.C. § 45(I).

[17] *See* 15 U.S.C. § 57b(a).

The situation in rulemaking is similar. The Commission's rulemaking authority was clarified and its powers to enforce its rules through the assessment of civil penalties were expanded in 1975, with the passage of the Magnuson Moss Federal Trade Commission Improvements Act. However, in granting the Commission this new authority, Congress also imposed procedural requirements on the rulemaking process that significantly exceed the protections that the Administrative Procedures Act affords participants in the proceedings of other agencies.[18] For example, participants in Magnuson Moss rulemakings have the right to conduct cross examination on disputed issues of material fact, to present oral testimony to the Commission, and to offer rebuttal evidence at various stages of the proceeding.[19] More recently Congress provided additional procedural protections to participants in FTC rulemakings. For example, the Commission is required to publish an "advance notice of proposed rulemaking" to obtain public input in the initial stages of a Commission inquiry, even before any particular rule provisions are proposed.[20] In addition, the Commission must issue a preliminary regulatory analysis weighing projected costs and benefits of any proposed rule and a final regulatory analysis when promulgating a final rule.[21] Finally, firms that are unsure whether certain activities are legally unfair are at all times invited to seek advisory opinions from the staff. **[9]**

First Amendment considerations

A third concern is that the First Amendment forbids the regulation of "unfair" but nondeceptive advertisements since

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[18] *See* 5 U.S.C. § 551 *et seq.*

[19] *See* 15 U.S.C. § 57a(c).

[20] *See* FTC Improvements Act of 1980, Pub. L. 96-252 (May 28, 1980) § 8, 15 U.S.C. § 57a(b).

[21] *Id.* at § 15, 15 U.S.C. § 57b-3.

these are essentially a form of protected commercial speech.[22] The Commission agrees that the First Amendment imposes stringent limitations upon the extent to which the government may regulate nondeceptive commercial speech, but further believes that the First Amendment does not entirely preclude such regulation.[23] Far from constituting a reason for eliminating the Commission's unfairness jurisdiction as it pertains to advertising, the First Amendment protections accorded commercial speech constitute a strong argument against the need for legislative modification of the unfairness mandate, since they already ensure that the unfairness clause may be applied to advertising only under limited circumstances.

Supreme Court decisions on commercial speech have made clear that deceptive commercial speech, and commercial speech that advocates an illegal activity, are entitled to no constitutional protections.[24] By contrast, commercial speech that neither deceives consumers nor advocates illegal conduct is entitled to substantial constitutional protection.[25] The extent of such protection was articulated by the Supreme Court in the recent case of *Central Hudson Gas and Electric*

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[22] This objection pertains to the Commission's unfairness authority only as it relates to advertising. The Commission's principal past uses of unfairness have occurred with respect to sales practices that did not involve commercial speech.

[23] *Central Hudson Gas and Electric Corp.* v. *Public Service Comm'n.* 100 S.Ct. 2343, 2351 (1980).

[24] *Virginia State Board of Pharmacy* v. *Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 771-72 (1976); *Central Hudson supra*, 100 S.Ct. at 2351.

[25] The Supreme Court has, however, upheld prophylactic measures designed to prevent serious risks of deception or coercion. In *Ohralik* v. *Ohio State Bar Ass'n*, 436 U.S. 447, 462 (1978), for example, the Court upheld a rule against in-person solicitation of clients by lawyers, suggesting that such rules could be valid even without specific findings that deception or coercion had actually occurred. *See also Friedman* v. *Rogers*, 99 S.Ct. 887, 896 (1979) (regulating conduct found to create "a significant possibility" of deception).

Corp. v. Public [10] *Service Comm'n.*[26] At issue in that case was a state regulation prohibiting public utilities from advertising to promote the increased use of electricity. The majority found that such commercial speech was entitled to some constitutional protection because it was not misleading and did not relate to unlawful activity. However, it then determined that such speech could still be regulated by the government consistently with the First Amendment provided that three criteria were met. First, the government must assert a substantial interest to be served by its regulation of commercial speech. Second, the restriction must directly advance the stated governmental interest. Finally, the restriction may not be more extensive than necessary.[27] The Supreme Court has thus generally described the boundaries of the government's authority to limit commercial speech that does not mislead or encourage illegal activity.

In the past the Commission has made sparing use of its unfairness authority to regulate commercial speech.[28] To the extent that it may need to exercise such authority in the future, it will do so in conformity with the standards established in *Central Hudson.* Moreover, the Commission recognizes that commercial speech questions involve a developing area of constitutional law. For example, *Central Hudson* did not define precisely when a governmental interest will be deemed substantial. Furthermore, the case involved state regulations and thus the considerations applied to the Commission's mandate to eliminate unfair practices may not be precisely the same.[29] The Commission will therefore proceed with caution as the courts continue to refine the standards for

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[26] 100 S.Ct. 2343 (1980).

[27] 100 S.Ct. at 2351.

[28] Indeed, in the Eyeglasses Rule the Commission used its unfairness authority to free commercial advertising from unjustified restrictions.

[29] Even apart from constitutional considerations, the Commission's need to consider consumer injury and public policy before determining whether a practice is unfair means that it has less freedom to take many of the regulatory actions that are open to the states.

governmental regulation of nondeceptive commercial speech. [11]

III. Conclusion

In short, three things may be said about the Commission's consumer unfairness jurisdiction. First, the Commission has sought to construe its jurisdiction in limited, specific, and market-oriented terms. Second, the Commission may be less able to reach many instances of significant consumer harm if its jurisdiction is limited to "deception." Third, the Commission has attempted to define its unfairness jurisdiction with sufficient particularity to answer criticisms that the law is excessively uncertain or is invoked in circumstances that threaten freedom of speech.

By direction of the Commission.

Carol M. Thomas
Secretary

DATED: December 17, 1980

APPENDIX E

Office of the Chairman

March 5, 1982

Honorable Bob Packwood
Chairman
Committee on Commerce, Science and Transportation
United States Senate
Washington, D.C. 20510

Honorable Bob Kasten
Chairman
Subcommittee on Consumer
Committee on Commerce, Science and Transportation
United States Senate
Washington, D.C. 20510

Dear Chairman Packwood and Chairman Kasten:

This is in response to your letter of February 24, 1982, in which you ask for the Commission's views with respect to our jurisdiction over state-regulated professionals and unfair acts or practices as currently defined in Section 5 of the Federal Trade Commission Act....

* * *

The Commission's Jurisdiction over "Unfair...Acts or Practices"

[7] By letter dated December 17, 1980, the Commission stated its general views concerning the definition of an unfair act or practice. The Commission felt that one of the most crucial elements in finding an act or practice to be unfair was that consumers be injured. The Commission listed three basic elements for evaluating consumer injury: (1) the injury must be substantial; (2) the injury must not be outweighed by any countervailing benefits to consumers or competition produced by the practice; and (3) the injury must be an injury that consumers could not reasonably have avoided.

As a federal body, the Commission believes its concerns should be with substantial injuries; its resources should not be used for trivial or speculative harm. As a general proposition, [8] substantial injury involves economic or monetary harm and does not cover subjective examples of harm such as emotional distress or offenses to taste or social belief.

In addition, the injury should not be outweighed by consumer or competitive benefits resulting from the challenged practice. Clearly, most business practices involve an economic and social mixture of costs and benefits; hence, unless a particular practice has the net effect of being injurious, the Commission should refrain from finding it unfair. In reaching its decision, the Commission should take into account costs related to a prospective remedy, including but not limited to direct cost to the parties, increased paperwork and regulatory burdens, reduced incentives for innovation and capital formation and like matters.

Finally, an unfair act or practice must be one which consumers could not reasonably have avoided. The Commission should not be involved in rectifying the unfortunate choice of a particular consumer decision. It should confine its activities to curb behavior that takes unfair advantage of consumers' inadequate knowledge in reaching a decision or inability to protect themselves from such behavior.

Additionally, although it is not a necessary element of the definition of unfairness, the Commission also looks to other established public policies in an effort to determine whether a particular practice is unfair. As the Commission indicated in its 1980 Policy Statement, reference to other public policies may provide additional evidence of consumer injury or, conversely, it may influence the Commission to reconsider its tentative view that a practice is injurious in its net effects and, therefore, unfair. A thorough analysis of such policies "can serve as an important check on the overall reasonableness of the Commission's action." Dec. 17, 1980 Policy Statement at page 10, note 27.

As a matter of practice, the Commission considers the foregoing factors in reaching any decision concerning an act or practice alleged to be unfair. That being so, it is appropriate and logical to include these three elements in a statutory definition of "unfairness". The codification of its acknowledged practices will not only aid the Commission but also consumers and sellers to understand the bounds of acceptable behavior without diminishing the ability of the Commission to police the marketplace.

In recommending the elements of a definition of consumer unfairness, the Commission recognizes the appropriateness of having Congress provide as much guidance as feasible to administrative agencies. Since the Commission has recently spelled out [9] the criteria it will utilize in defining unfairness, codification of those criteria can help to provide specific guidance for those regulated as well as the regulator.

As to the element pertaining to the weighing of benefits and costs, however, the Commission believes there is an associated problem to consider, namely the risk that the analysis might unnecessarily complicate and delay an investigation or an ultimate litigation. For this reason, the Commission believes that a highly quantitative benefit/cost analysis may not be appropriate in each and every individual case, and that in some cases a far more subjective analysis would be the reasonable approach. We believe any legislative history of a refined definition of unfairness should reflect this view.

We appreciate this opportunity to comment on two of the central questions being addressed by the Congress during the reauthorization process.

By direction of the Commission.

James C. Miller III
Chairman